income families are discussed, as are the barriers that minorities face when attempting to become homeowners. This discussion serves to provide useful background information for the discussion of the Geographically Targeted and Special Affordable Housing Goals in Appendixes B and C, as well as for the Low- and Moderate-Income Housing Goal in this Appendix.

The third factor (past performance) and the fifth factor (ability of the GSEs to lead the industry) are also discussed in some detail in this Appendix. With respect to home purchase mortgages, the past performance of the GSEs and their ability to lead the industry are examined for all three housing goals; that analysis provides the basis for establishing the three subgoals for the GSEs' acquisitions of home loans on single-family-owner properties.

The fourth factor (size of the market) and the sixth factor (need to maintain the GSEs' sound financial condition) are mentioned only briefly in this Appendix. Detailed analyses of the fourth factor and the sixth factor are contained in Appendix D and in the economic analysis of this rule, respectively.

The factors are discussed in sections B through H of this appendix. Section I summarizes the findings and presents the Department's conclusions concerning the Low- and Moderate-Income Housing Goal. Section I also gives the rationale for a low- and moderate-income subgoal for home purchase loans.

The consideration of the factors in this Appendix has led the Secretary to the following conclusions:

- Changing population demographics will result in a need for primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences, and overcome information and other barriers that many immigrants and minorities face. Growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. Immigrants and other minorities—who accounted for more than a third of household growth since the 1990s—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new renters and homeowners.
- Despite the record national homeownership rate of 68.3 percent in 2003, much lower rates prevailed for minorities, especially for African-American households (48.4 percent) and Hispanics (47.4 percent), and these lower rates are only partly accounted for by differences in income, age, and other socioeconomic factors.
- In addition to low incomes, barriers to homeownership that disproportionately affect minorities and immigrants include lack of capital for down payments and closing costs, poor credit history, lack of access to mainstream lenders, little understanding of the homebuying process, and continued discrimination in housing markets and mortgage lending.
- A HUD-published study of discrimination in the rental and owner markets found that while differential treatment between minority and white home seekers had declined over the past ten years, it continued at an unacceptable level in the year 2000. In addition, disparities in mortgage lending continued across the nation in 2002, when the loan denial rate was 7.8 percent for white mortgage applicants, but 20.1 percent for African Americans and 15.5 percent for Hispanics.[1]
- Americans with the lowest incomes face persistent housing problems. Recent HUD analysis reveals that in 2001, 5.1 million households had ''worst case'' housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing among unassisted very-low-income renter households. Among these households, 90 percent had a severe rent burden, 6 percent lived in severely inadequate housing, and 4 percent suffered from both problems.
- Over the past ten years, there has been a ''revolution in affordable lending'' that has extended homeownership opportunities to historically underserved households. Fannie Mae and Freddie Mac have been a substantial part of this ''revolution in affordable lending''. During the mid-to-late 1990s, they added flexibility to their underwriting guidelines, introduced new low-down-payment products, and worked to expand the use of automated underwriting in evaluating the creditworthiness of loan applicants. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low-income and minority families increased at much faster rates than loans to upper-income and non-minority families.
- The Low- and Moderate-Income Goal was set at 50 percent beginning in 2001. Effective on January 1, 2001, several changes in counting requirements came into effect, including (1) ''bonus points'' (double credit) for purchases of mortgages on small (5–50 unit) multifamily properties and, above a threshold level, mortgages on 2–4 unit owner-occupied properties; and (2) a ''temporary adjustment factor'' (1.35 units credit) for Freddie Mac's purchases of mortgages on large (>50 unit) multifamily properties. With these two counting rules, Fannie Mae's performance was 51.5 percent in 2001, 51.8 percent in 2002 and 52.3 percent in 2003, and Freddie Mac's performance was 53.2 percent in 2001, 50.5 percent in 2002, and 51.2 percent in 2003; thus, both GSEs surpassed this higher goal in all three years.
- The bonuses and temporary adjustment factor expired at the end of 2003. Without these rules, Fannie Mae's performance would have been 51.3 percent in 2000, 49.2 percent in 2001, 49.0 percent in 2002, and 48.7 percent in 2003. Freddie Mac's performance would have been 50.6 percent in 2000, 47.7 percent in 2001, 46.1 percent in 2002, and 45.0 percent in 2003. Thus, both Fannie Mae and Freddie Mac would have surpassed the 50 percent goal in 2000 and fallen short in 2001, 2002, and 2003.
- This Appendix includes a comprehensive analysis of each GSE's performance in funding home purchase mortgages for borrowers and neighborhoods covered by the three housing goals—special affordable and low- and moderate-income borrowers and underserved. The GSEs' performance in funding first-time home buyers is also examined.
- While Freddie Mac has improved its affordable lending performance in recent years, it has consistently lagged the conventional conforming market in funding affordable home purchase loans for special affordable and low-moderate-income borrowers and underserved neighborhoods targeted by the housing goals.[2] In 2003, its performance on the underserved areas goal was particularly low relative to both the performances of Fannie Mae and the market; in that year, underserved area loans accounted for only 24.0 percent of Freddie Mac's purchases compared with 26.8 percent of Fannie Mae's purchases and 27.6 percent of market originations. (These underserved area data are based on 1990 Census geography.)
- In general, Fannie Mae's affordable lending performance has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance during past periods (*e.g.*, 1993–2003, 1996–2003, 1999–2003) has been below market levels. However, it is encouraging that Fannie Mae markedly improved its affordable lending performance relative to the market during 2001, 2002, and 2003, the first three years under the higher housing goal targets that HUD established in the GSE Final Rule dated October 2000. Over this three-year period, Fannie Mae led the primary market in funding special affordable and low-mod loans but lagged the market in funding underserved areas loans. In 2003, Fannie Mae's increased performance placed it significantly above the special affordable market (a 17.1 percent share for Fannie Mae compared with a 15.9 percent share for the market) and the low-mod market (a 47.0 percent share for Fannie Mae compared with a 44.6 percent share for the market). However, Fannie Mae continued to lag the underserved areas market in 2003 (a 26.8 percent share for Fannie Mae compared with a 27.6 percent share for the market). In this case, which is referred to in the text as the ''purchase year'' approach, Fannie Mae's performance is based on comparing its purchases of all loans (both seasoned loans and newly-originated mortgages) during a particular year with loans originated in the market in that year. When Fannie Mae's

[1] Mortgage denial rates are based on 2002 HMDA data for home purchase loans; manufactured housing lenders are excluded from these comparisons.

[2] The ''affordable lending performance'' of Fannie Mae and Freddie Mae refers to the performance of the GSEs in funding loans for low-income and underserved borrowers through their purchase (or guarantee) of loans originated by primary lenders. It does not, of course, imply that the GSEs themselves are lenders originating loans in the primary market.

performance is measured on an ''origination year'' basis (that is, allocating Fannie Mae's purchases in a particular year to the year that the purchased loan was originated), Fannie Mae also led the 2003 market in funding special affordable and low- and moderate-income loans, and lagged the market in funding underserved area loans.

- Both Fannie Mae and Freddie Mac lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.
- The GSEs have accounted for a significant share of the total (government as well as conventional) market for home purchase loans, but their market share for each of the affordable lending categories (*e.g.*, low-income borrowers and census tracts) has been less than their share of the overall market.
- The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or approximately one-half of their share (57 percent) of all home purchase loans in that market. The GSEs' small share of the first-time homebuyer market could be due to the preponderance of high (over 20 percent) downpayment loans in their mortgage purchases.
- This Appendix discusses the dynamic nature of the single-family mortgage market and the numerous changes that this market has undergone over the past few years. Some important trends that will likely factor into the GSEs' performance in meeting the needs of underserved borrowers include the growth of the subprime market, the increasing use of automated underwriting systems, and the introduction of risk-based pricing into the market.
- The long run outlook for the multifamily rental market is sustained, moderate growth, based on favorable demographics. The minority population, especially Hispanics, provides a growing source of demand for affordable rental housing. ''Lifestyle renters'' (older, middle-income households) are also a fast-growing segment of the rental population. Provision of affordable housing, however, will continue to challenge suppliers of multifamily rental housing and policy makers at all levels of government. Low incomes combined with high housing costs define a difficult situation for millions of renter households. Housing cost reductions are constrained by high land prices and construction costs in many markets. Government action—through land use regulation, building codes, and occupancy standards—are major contributors to those high costs.
- The market for financing multifamily apartments has grown to record volumes. Fannie Mae and Freddie Mac have been among those boosting volumes and introducing new programs to serve the multifamily market. Fannie Mae's multifamily purchases jumped from about $10 billion in 1999 and 2000 to $18.7 billion in 2001, $18.3 billion in 2002, and $33.3 billion in 2003—the last three years were characterized by heavy refinancing activity.
- Freddie Mac has re-entered the multifamily market, after withdrawing for a time in the early 1990s. Concerns regarding Freddie Mac's multifamily capabilities no longer constrain its performance with regard to the housing goals. Freddie Mac's multifamily purchases increased from a relatively low $3 billion in 1997 to approximately $7 billion during the next three years (1998 to 2000), before rising further to $11.9 billion in 2001, $13.3 billion in 2002, and $21.6 billion in 2003.
- The overall presence of both GSEs in the rental mortgage market falls short of their involvement in the single-family owner market. Between 1999 and 2002, the GSEs' purchases totaled for 61 percent of the owner market, but only 37 percent of the single-family rental and multifamily rental market. Certainly there is room for expansion of the GSEs in supporting the nation's rental markets, and that expansion is needed if the GSEs are to make significant progress in closing the gaps between the affordability of their mortgage purchases and that of the overall conventional conforming market.
- Considering both owner and rental properties, the GSEs' presence in the goals-qualifying market has been significantly less than their presence in the overall conventional conforming mortgage market. Specifically, HUD estimates that the GSEs accounted for 55 percent of all owner and rental units financed in the primary market between 1999 and 2002, but only 48 percent of units qualifying for the low-mod goal, 48 percent of units qualifying for the underserved areas goal, and 41 percent of units qualifying for special affordable goal.

B. Factor 1: National Housing Needs

This section reviews the general housing needs of lower-income families that exist today and are expected to continue in the near future. Affordability problems that lower-income families face in both the rental and owner markets are examined. The section also describes racial disparities in homeownership and the causes of these disparities. It also notes some special problems, such as the need to rehabilitate our older urban housing stock, that are discussed throughout this appendix.

1. Homeownership Gaps

Despite recent record homeownership rates, many Americans, including disproportionate numbers of racial and ethnic minorities, are shut out of homeownership opportunities. Although the national homeownership rate for all Americans was 68.3 percent in 2003, the rate for minority households was lower—for example, just 48.4 percent of African-American households and 47.4 percent of Hispanic households owned a home.[3] Differences in income and age between minorities and whites do not fully explain these gaps. The Joint Center for Housing Studies estimated that if minorities owned homes at the same rates as whites of similar age and income, a homeownership gap of 10 percentage points would still exist.[4]

a. Importance of Homeownership

Homeownership is one of the most common forms of property ownership as well as savings.[5] Historically, home equity has been the largest source of wealth for most Americans, and wealth gains in housing have been more widely distributed among the population than gains in the stock market.[6] With stocks appreciating faster than home prices over the past decade, home equity as a share of all family assets fell from 38 percent in 1989 to 33 percent in 1998 and 32 percent in 2001.[7] However, many of the gains in the stock market were erased after 1999 and housing was once again a more significant asset in the household balance sheet than stocks in 2001.[8] Even with a bull market through most of the 1990s, 59 percent of all homeowners in 1998 held more than half of their net wealth in the form of home equity.[9] From 2001 to 2003, homes prices appreciated an average of 23 percent which meant $30,900 in housing equity accumulation for a typical homeowner.[10] Moreover, unlike stock wealth, aggregate home equity has steadily increased over the past 40 years with only occasional small dips.[11]

Among low-income homeowners (household income less than $20,000), home equity accounted for about 72 percent of household wealth, and approximately 55 percent for homeowners with incomes between $20,000 and $50,000. Median net wealth for low-income homeowners under 65

[3] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2004,* p. 35.

[4] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2003,* p. 16.

[5] According to the National Association of Realtors, *Housing Market Will Change in New Millennium as Population Shifts,* November 7, 1998. Forty-five percent of U.S. household wealth was in the form of home equity in 1998. Since 1968, home prices have increased each year, on average, at the rate of inflation plus two percentage points.

[6] Todd Buchholz, ''Safe At Home: The New Role of Housing in the U.S. Economy,'' a paper commissioned by the Homeownership Alliance, 2002.

[7] Federal Reserve Board, ''Recent Changes in U.S. Family Finances: Results from the 1998 and 2001 Survey of Consumer Finances,'' January 2003, p. 16.

[8] Mark Zandi, ''Housing's Rising Contribution,'' June 2002, p. 5.

[9] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998.*

[10] Lawrence Yun, ''The Forecast,'' National Association of Realtors Real Estate Outlook, February 2004, p. 4.

[11] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2004,* p. 15.

was twelve times that of a similar renter.[12] Thus a homeownership gap continues to translate directly into a wealth gap. For this reason, President Bush issued the ''Homeownership Challenge'' in June 2002 to increase minority homeownership by 5.5 million by the end of the decade. By December of 2003, the Census estimated that the number of minority homeowners had increased by 1.53 million. Meaning that in the fourth quarter of 2003, for the first time ever, the majority of minority households are homeowners.[13]

High rates of homeownership support economic stability within housing and related industries, sectors that contributed nearly one-third of the total gain in real GDP since the beginning of the decade.[14] In addition, more than half of the refinancing mortgages in the first two years of the decade were cash-out, defined as refinancing procedures by which the mortgage balance is increased by more than five percent in order to tap into home equity. Cash-outs injected more than $300 billion into the economy between 2000 and 2002 and were responsible for one-fifth of real GDP growth since during that period.[15] In addition to economic benefits such as jobs and residential investment, studies show that the better living environment associated with owning a home has positive impacts on children, in terms of lower rates of teenage pregnancy and higher reading other test scores. The current literature substantiates that the benefits of homeownership extend beyond individual homeowners and their families to society at large. Homeownership promotes social and community stability by increasing the number of stakeholders and reducing disparities in the distributions of wealth and income. The empirical literature is generally supportive of a relationship between homeownership and greater investment in property.[16] Homeownership is also associated with neighborhood stability (lower mobility), greater participation in voluntary and political activities,[17] and links to entrepreneurship.[18]

b. Barriers to Homeownership [19]

Insufficient income, high debt burdens, and limited savings are obstacles to homeownership for younger families. As home prices skyrocketed during the late 1970s and early 1980s, real incomes also stagnated, with earnings growth particularly slow for blue collar and less educated workers. Through most of the 1980s, the combination of slow income growth and increasing rents made saving for home purchase more difficult, and relatively high interest rates required large fractions of family income for home mortgage payments. Thus, during that period, fewer households had the financial resources to meet down payment requirements, closing costs, and monthly mortgage payments.

Economic expansion and lower mortgage rates substantially improved homeownership affordability during the 1990s. Many young, low-income, and minority families who were closed out of the housing market during the 1980s re-entered the housing market during the last decade. Even with an economic slowdown in 2000–2001 and climbing house appreciation in 2002–2003, after-tax mortgage payments fell in 2003 for buyers of median priced homes because of historically low interest rates.[20] However, many households still lack the earning power to take advantage of today's home buying opportunities. Several trends have contributed to the reduction in the real earnings of young adults without college education over the last 15 years, including technological changes that favor white-collar employment, losses of unionized manufacturing jobs, and wage pressures exerted by globalization. Over 42 percent of the nation's population between the ages of 25 and 34 had no advanced education in 2000[21] and were therefore at risk of being unable to afford homeownership. African Americans and Hispanics, who have lower average levels of educational attainment than whites, are especially disadvantaged by the erosion in wages among less educated workers.

Immigrants and other minorities, who accounted for nearly 40 percent of the growth in the homeownership rate over the past five years, will be responsible for two-thirds of the growth in new households over the next ten years. These groups have unique housing needs and face numerous hurdles in becoming homeowners. In addition to low income, barriers to homeownership that disproportionately affect minorities and immigrants include:

(1) Lack of capital for down payment and closing costs;

(2) Poor credit history;

(3) Lack of access to mainstream lenders;

(4) Complexity and fear of the home buying process; and,

(5) Continued discrimination in housing markets and mortgage lending.

(i) *Lack of Cash for Down Payment.* In the 2002 Fannie Mae National Housing Survey, 40 percent of Hispanics reported not having enough money for a down payment as an obstacle to buying a home versus 32 percent of all Americans.[22] A study by Gyourko, Linneman, and Wachter found significant racial differences in homeownership rates in ''wealth-constrained'' households while finding no racial differences in homeownership rates among households with wealth sufficient to meet down payment and closing costs.[23] Minorities and immigrants are much less likely to receive gifts and inheritances from their parents to assist them in becoming a homeowner.

(ii) *Poor Credit History.* Poor credit history also differentially affects minority households. In the same Fannie Mae survey, nearly a third of African-American respondents said their credit rating would be an obstacle to buying a home versus 23 percent of all Americans.[24] Because African-American and Hispanic borrowers are more likely than others to have little traditional credit history or a poorer credit history, they face increased difficulties in being accepted for mortgage credit. This is because credit history scores (such as a FICO score) are a major component of the new automated mortgage scoring systems. These systems are more likely to refer minority borrowers for more intensive manual underwriting, rather than to automatically accept them for the less costly, expedited processing. In these situations, there is the additional concern that ''referred'' borrowers may not always receive a manual underwriting for the loan that they initially applied for, but rather be directed to a high-cost subprime loan product.

(iii) *Lack of Access to Mainstream Lenders.* Minorities face heightened barriers in accessing credit because of their often limited access to mainstream lenders. Access to lenders becomes difficult when mainstream financial institutions are not located in neighborhoods where minorities live. The growth in subprime lending over the last several years has benefited credit-impaired borrowers—those who may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. Subprime lenders have allowed these borrowers to access credit that they could not otherwise obtain in the prime credit market. However, studies by HUD, The Woodstock Institute and others have shown that subprime lending is disproportionately concentrated in low-income and minority neighborhoods.[25] While these studies

[12] U.S. Department of Housing and Urban Development, ''Economic Benefits of Increasing Minority Homeownership,'' p. 7.

[13] *http://www.whitehouse.gov/infocus/homeownership/.* Accessed July 28, 2004.

[14] Homeownership Alliance, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 2.

[15] Homeownership Alliance, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 4–5.

[16] Robert Dietz and Donald Haurin, ''The Social and Private Consequences of Homeownership,'' May 2001, p. 51.

[17] William M. Rohe, George McCarthy, and Shannon Van Zandt, ''The Social Benefits and Costs of Homeownereship,'' May 2000, p. 31.

[18] U.S. Deparmtent of Housing and Urban Development, ''Economic Beneifts of Increasing Minority Homeownership,'' p. 8–9.

[19] For a dicusssion of the causes of existing disparities in homeownership, see the various articles in Nicolas P. Retsinas and Eric S. Belsky (Eds), *Low-Income Homeowernsip: Examining the Unexamined Goal,* Washington, DC: Brookings Institution Press, 2002.

[20] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2004,* p. 15.

[21] U.S. Census Bureau, *Current Population Survey,* March 2000.

[22] Fannie Mae, *Fannie Mae National Housing Survey,* 2002, p. 11.

[23] Joseph Gyourko, Peter Linneman, and Susan Wachter. ''Analyzing the Relationships among Race, Wealth, and Home Ownership in America,'' *Journal of Housing Economics* 8 (2), p. 63–89, as discussed in Thomas P. Boehm and Alan M. Schlottmann. ''Housing and Wealth Accumulation: Intergenerational Impacts,'' in *Low-Income Homeownership: Examining the Unexamined Goal,* Brookings Institution Press (2002), p. 408.

[24] Fannie Mae, *Fannie Mae National Housing Survey,* 2002, p. 11.

[25] See Dan Immergluck, *Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending,* Woodstock Institute, October 2000; and Daniel Immergluck and Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the*

Continued

recognize that differences in credit behavior explain some of the disparities in subprime lending across neighborhoods, they argue that the absence of mainstream lenders has also contributed to the concentration of subprime lending in low-income and minority neighborhoods. More competition by prime lenders in inner city neighborhoods could lower the borrowing costs of families who currently have only the option of a high-cost subprime loan. This issue of the lack of mainstream lenders in inner city neighborhoods is discussed further in subsection 2, below, in connection with disparities between neighborhoods.

(iv) *Complexity and Fear of Homebuying Process.* An additional barrier to homeownership is fear and a lack of understanding about the buying process and the risks of ownership. Many Americans could become homeowners if provided with information to correct myths, misinformation, and concerns about the mortgage process. Some potential homeowners, particularly minorities, are unaware that they may already qualify for a mortgage they can afford. The 2002 Fannie Mae survey revealed that 30 percent of Americans believe erroneously that they need to pay 20 percent of the cost of a home up-front. In addition, Fannie Mae reported that half of Americans are only ''somewhat'' or ''not at all'' comfortable with mortgage terms.[26] Freddie Mac reports that six of 10 Hispanics are uncomfortable with home buying terminology, and think they need ''perfect credit'' to buy; and less than four in 10 are aware that lenders are not required by law to give them the lowest interest rate possible.[27] A study using focus groups with renters found that even among those whose financial status would make them capable of homeownership, many felt that the buying process was insurmountable because they feared rejection by the lender or being taken advantage of.[28]

(v) *Discrimination in the Housing and Mortgage Markets.* Finally, differential treatment of minorities in the sales and rental markets and in the mortgage lending market has been well documented. The continued discrimination in these markets is discussed in the next section.

2. Disparities in Housing and Mortgage Markets

Sales and Rental Markets. In 2002, HUD released its third Housing Discrimination Study (HDS) in the sale and rental of housing. The study, entitled *Discrimination in Metropolitan Housing Markets: National Results from Phase I of The Housing Discrimination Study* was conducted by the Urban Institute.[29] This results of this HDS were based on 4,600 paired tests of minority and non-minority home seekers conducted during 2000 in 23 metropolitan areas nationwide. The report showed large decreases between 1989 and 2000 in the level of discrimination experienced by Hispanics and African Americans seeking to buy a home. There has also been a modest decrease in discrimination toward African Americans seeking to rent a unit. This downward trend, however, has not been seen for Hispanic renters, who now are more likely to experience discrimination in their housing search than do African-American renters. But while generally down since 1989, the report found that housing discrimination still exists at unacceptable levels. The greatest share of discrimination for Hispanic and African-American home seekers can still be attributed to being told units are unavailable when they are available to non-Hispanic whites, and being shown and told about fewer units than comparable non-minority home seekers. Although discrimination is down on most areas for African-American and Hispanic homebuyers, there remain worrisome upward trends of discrimination in the areas of geographic steering for African Americans and, relative to non-Hispanic whites, the amount of help agents provide to Hispanics with obtaining financing. On the rental side, Hispanics were more likely in 2000 than in 1989 to be quoted a higher rent than their white counterpart for the same unit.

Another HUD-sponsored study asked respondents to a nationwide survey if they ''thought'' they had ever been discriminated against when trying to buy or rent a house or an apartment.[30] While the responses were subjective, they are consistent with the findings of the HDS. African Americans and Hispanics were considerably more likely than whites to say they have suffered discrimination—24 percent of African Americans and 22 percent of Hispanics perceived discrimination, compared to only 13 percent of whites.

Mortgage Lending Market. Research based on Home Mortgage Disclosure Act (HMDA) data suggests pervasive and widespread disparities in mortgage lending across the Nation. For 2001, the mortgage denial rate for white mortgage applicants was 23 percent, while 36 percent of African-American and 35 percent of Hispanic applicants were denied.

Two recent HUD-sponsored studies of paired-testing at the mortgage pre-application stage also points to discrimination by mortgage lenders. Based on its review of pair tests conducted by the National Fair Housing Alliance, the Urban Institute concluded that differential treatment discrimination at the pre-application level occurred at significant levels in at least some cities.[31] Minorities were less likely to receive information about loan products, received less time and information from loan officers, and were quoted higher interest rates in most of the cities where tests were conducted. A second HUD-sponsored study by the Urban Institute used the paired testing methodology in Los Angeles and Chicago and found similar results. African Americans and Hispanics faced a significant risk of unequal treatment when they visited mainstream mortgage lending institutions to make pre-application inquiries.[32]

Several possible explanations for these lending disparities have been suggested. A study by the Boston Federal Reserve Bank found that racial disparities cannot be explained by reported differences in creditworthiness.[33] In other words, minorities are more likely to be denied than whites with similar credit characteristics, which suggests lender discrimination. In addition, loan officers, who may believe that race is correlated with credit risk, may use race as a screening device to save time, rather than devote effort to distinguishing the creditworthiness of the individual applicant.[34] This violates the Fair Housing Act.

Underwriting rigidities may fail to accommodate creditworthy low-income or minority applicants. For example, under traditional underwriting procedures, applicants who have conscientiously paid rent and utility bills on time but have never used consumer credit would be penalized for having no credit record. Applicants who have remained steadily employed, but have changed jobs frequently, would also be penalized. As discussed in Section C below, lenders, private mortgage insurers, and the GSEs have been adjusting their underwriting guidelines to take into account these special circumstances of lower-income families. Many of the changes recently undertaken by the industry focused on finding alternative underwriting guidelines to establish creditworthiness that do not disadvantage creditworthy minority or low-income applicants. However, because of the enhanced roles of credit scoring and automated underwriting in the mortgage origination process, it is unclear to what

Undoing of Community Development, Woodstock Institute, Chicago, IL, November 1999. For a national analyses, see the HUD report *Unequal Burden: Income and Racial Disparities in Subprime Lending in America,* April 2000; and Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending,* Housing Finance Working Paper No. HF–114, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, April 2002.

[26] Fannie Mae, *Fannie Mae National Housing Survey,* 2002, p. 9.

[27] See ''Immigration Changes Won't Hurt Housing,'' in *National Mortgage News,* January 27, 2003, p. 8.

[28] Donald S. Bradley and Peter Zorn, ''Fear of Homebuying: Why Financially Able Households May Avoid Ownership,'' *Secondary Mortgage Markets,* 1996.

[29] Margery Austin Turner, Stephen L. Ross, George Galster, and John Yinger, ''Discrimination in Metropolitan Housing Markets,'' *The Urban Institute Press*, November 2002.

[30] Martin D. Abravanel and Mary K. Cunningham, *How Much Do We Know? Public Awareness of the Nation's Fair Housing Laws.* A report prepared for HUD by the Urban Institute, Washington, DC, April 2002.

[31] Margery Austin Turner, John Yinger, Stephen Ross, Kenneth Temkin, Diane Levy, David Levine, Robin Ross Smith, and Michelle deLair, *What We Know About Mortgage Lending Discrimination*, The Urban Institute, contract report for the Department of Housing and Urban Development, December 1998.

[32] Margery Austin Turner, *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*, The Urban Institute Press, April 2002.

[33] Alicia H. Munnell, Geoffrey M.B. Tootell, Lynn E. Browne, and James McEneaney, ''Mortgage Lending in Boston: Interpreting HMDA Data,'' *American Economic Review*, 86, March 1996.

[34] See Charles W. Calomeris, Charles M. Kahn and Stanley D. Longhofer, ''Housing Finance Intervention and Private Incentives: Helping Minorities and the Poor,'' *Journal of Money, Credit and Banking*, 26, August 1994, pp. 634–74, for more discussion of this phenomenon, which is called ''statistical discrimination.''

degree the reduced rigidity in industry standards will benefit borrowers who have been adversely impacted by the traditional guidelines as discussed in section C.7, some industry observers have expressed a concern that the greater flexibility in the industry's written underwriting guidelines may not be reflected in the numerical credit and mortgage scores which play a major role in the automated underwriting systems that the GSEs and others have developed.

Disparities Between Neighborhoods. Mortgage credit also appears to be less accessible in low-income and high-minority neighborhoods. As discussed in Appendix B, 2001 HMDA data show that mortgage denial rates are nearly twice as high in census tracts with low-income and/or high-minority composition, as in other tracts (16.8 percent versus 8.7 percent). Numerous studies have found that mortgage denial rates are higher in low-income census tracts, even accounting for other loan and borrower characteristics.[35] These geographical disparities can be the result of cost factors, such as the difficulty of appraising houses in these areas because of the paucity of previous sales of comparable homes. Sales of comparable homes may also be difficult to find due to the diversity of central city neighborhoods. The small loans prevalent in low-income areas are less profitable to lenders because up-front fees to loan originators are frequently based on a percentage of the loan amount, although the costs incurred are relatively fixed. As noted above, racial disparities in mortgage access may be due to the fact that mainstream lenders are not doing business in certain inner city neighborhoods. There is evidence that mainstream lenders active in white and upper-income neighborhoods are much less active in low-income and minority neighborhoods—often leaving these neighborhoods to unregulated subprime lenders. Geographical disparities in mortgage lending are discussed further in Section C.8 below (which examines subprime lending) and in Appendix B (which examines the Geographically Targeted Goal).

3. Affordability Problems and Worst Case Housing Needs

The severe affordability problems faced by low-income homeowners and renters are documented in HUD's ''Worst Case Housing Needs'' reports. These reports, which are prepared biennially for Congress, are based on the American Housing Survey (AHS), conducted every two years by the Census Bureau for HUD. The latest detailed report analyzes data from the 1999 AHS. Although it focuses on the housing problems faced by very-low-income renters, it also presents basic data on families and households in owner-occupied housing.[36]

The ''Worst Case'' report measures three types of problems faced by homeowners and renters:

1. Cost or rent burdens where housing costs or rent exceed 50 percent of income (a ''severe burden'') or range from 31 percent to 50 percent of income (a ''moderate burden'');
2. The presence of physical problems involving plumbing, heating, maintenance, hallway, or the electrical system, which may lead to a classification of a residence as ''severely inadequate'' or ''moderately inadequate;'' and,
3. Crowded housing, where there is more than one person per room in a residence.

The study reveals that in 2001, 5.1 million very low income renter households had ''worst case'' housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing among unassisted very-low-income renter households.[37] Among the 5.1 million worst case needs renters, 4.8 million (94 percent) had a severe rent burden and 10 percent of renters lived in housing that was severely inadequate.

a. Problems Faced by Owners

Of the 68.8 million owner households in 1999, 5.8 million (8 percent) confronted a severe cost burden and another 8.7 million (12.7 percent) faced a moderate cost burden. There were 870,000 households with severe physical problems, 2 million with moderate physical problems and 905,000 that were overcrowded. The report found that 25 percent of American homeowners faced at least one severe or moderate problem.

Not surprisingly, problems were most common among very low-income owners.[38] Almost a third of these households (31 percent) faced a severe cost burden, and an additional 22 percent faced a moderate cost burden. And 8 percent of these families lived in severely or moderately inadequate housing, while 2 percent faced overcrowding. Only 42 percent of very-low-income owners reported no problems.

Over time the percentage of owners faced with severe or moderate physical problems has decreased, as has the portion living in overcrowded conditions. However, affordability problems have become more common—the shares facing severe (moderate) cost burdens were only 3 percent (5 percent) in 1978, but rose to 5 percent (11 percent) in 1989 and 8 percent (13 percent) in 1999. The increase in affordability problems apparently reflects a rise in mortgage debt in the late 1980s and early 1990s, from 21 percent of homeowners' equity in 1983 to 36 percent in 1995.[39] The Joint Center for Housing Studies also attributes this to the growing gap between housing costs and the incomes of the nation's poorest households.[40] As a result of the increased incidence of severe and moderate cost burdens, the share of owners reporting no problems fell from 84 percent in 1978 to 78 percent in 1989 and 75 percent in 1999.

Between 1999 and 2001, the number of low income owners with severe cost burdens (meaning those with incomes below 120 percent of AMI and spending more than half of their reported income on housing) shot up by one million. This increase proved to be the main cause of a highly significant nine percent jump in the overall number of low and moderate income owners and renters with critical housing needs. Part of this could be due to the heavy home equity borrowing that has characterized the housing market from the late 1990s to the present day, as well as the fact that increases in house prices have outpaced increases in household income. As a corollary, subprime lending, especially in minority communities, rose by about ten percentage points from the early 1990s to 2001.[41]

b. Problems Faced by Renters

Problems of all three types listed above are more common among renters than among homeowners. In 1999 there were 6.3 million renter households (19 percent of all renters) who paid more than 50 percent of their income for rent.[42] Another 7.1 million faced a moderate rent burden. Thus in total 40 percent of renters paid more than 30 percent of their income for rent.

Among very-low-income renters, 71 percent faced an affordability problem, including 40 percent who paid more than half of their income in rent. Almost one-third (31 percent) of renters with incomes between 51 percent and 80 percent of area median family income also paid more than 30 percent of their income for rent.

Affordability problems have increased over time among renters. The shares of renters with severe or moderate rent burdens rose from 32 percent in 1978 to 36 percent in 1989 and 40 percent in 1999.

The share of households living in inadequate housing in 1999 was higher for renters (11 percent) than for owners (4 percent), as was the share living in overcrowded housing (5 percent for renters, but only 1 percent for owners). Crowding and inadequate housing were more common among lower-income renters, but among even the lowest income group, affordability was the dominant problem. The prevalence of inadequate and crowded rental housing diminished over time until 1995, while affordability problems grew.

Other problems faced by renters discussed in the most recent detailed ''Worst Case'' report include a sharp decline (of 2.3 million,

[35] Robert B. Avery, Patricia E. Beeson and Mark E. Sniderman, *Understanding Mortgage Markets: Evidence from HMDA*, Working Paper Series 94–21, Federal Reserve Bank of Cleveland, December 1994.

[36] HUD has published an update on ''worst case housing needs,'' which found that the number of such households rose from 4.86 million in 1999 to 5.07 million in 2001. However, detailed tables for 2001 have not been published.

[37] This does not constitute a significant difference from the 1999 figure of 4.9 million households. However, when the focus is narrowed to renters with incomes below 50 percent of AMI, a statistically significant change emerges; there were 4 percent fewer units affordable to this group in 2001 than there were in 1999.

[38] Very-low-income households are defined as those whose income, adjusted for household size, does not exceed 50 percent of HUD-adjusted area median income. This differs from the definition adopted by Congress in the GSE Act of 1992, which uses a cutoff of 60 percent and which does not adjust income for family size for owner-occupied dwelling units.

[39] Edward N. Wolff, ''Recent Trends in the Size Distribution of Household Wealth,'' *The Journal of Economic Perspectives,* 12(3), (Summer 1998), p. 137.

[40] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing: 2000,* p. 24.

[41] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2004.* p. 1–2, 4.

[42] Rent is measured in this report as gross rent, defined as contract rent plus the cost of any utilities that are not included in contract rent.

or 14 percent) between 1991 and 1999 in the number of rental units affordable to very-low-income families, and a worsening of the national shortage of units affordable and available to extremely-low-income families (those with incomes below 30 percent of area median income). In 2001, the shortage for extremely-low-income families was approximately 5 million units, not statistically different from the 1999 number. However, between 1999 and 2001, the number of units available to renters with incomes below 50 percent of AMI dropped from 78 units to 76 units per 100 renters, in part because more of the units affordable to this group of renters were occupied by higher-income renters. Shortages of units affordable and available to extremely-low-income households were most pressing in the West and Northeast, especially in metropolitan areas in those regions. In 2001, the West was the only region to experience a significant decline in number of units affordable to renters with incomes below 50 percent of AMI. This decline occurred even in the wake of an increase in affordable units in the West during the 1990s.

4. Rehabilitation and Other National Housing Needs

In addition to the broad housing needs discussed above, there are additional needs confronting specific sectors of the housing and mortgage markets. One example of these specific needs concerns the rehabilitation of the nation's older housing stock. A major problem facing lower-income households is that low-cost housing units continue to disappear from the existing housing stock. Older properties are in need of upgrading and rehabilitation. These aging properties are concentrated in central cities and older inner suburbs, and they include not only detached single-family homes, but also small multifamily properties that have begun to deteriorate. But obtaining the funds to fix up older properties can be difficult. The owners of small rental properties in need of rehabilitation may be unsophisticated in obtaining financing. The properties are often occupied, and this can complicate the rehabilitation process. Lenders may be reluctant to extend credit because of a sometimes-inaccurate perception of high credit risk involved in such loans. The GSEs and other market participants have recently begun to pay more attention to these needs for financing of affordable rental housing rehabilitation. However, extra effort is required, due to the complexities of rehabilitation financing, as there is still a need to do more.

The rehabilitation of our aging housing stock is but one example of the housing and mortgage issues that need to be addressed. Several other examples will be provided throughout the following sections on the economic, housing, and demographic conditions in the single-family and multifamily markets, as well as in Appendices B–D. The discussion will cover a wide range of topics, such as subprime lending, predatory lending, automated underwriting systems, manufactured housing, the special needs of the single-family rental market, and challenges associated with producing affordable multifamily housing—just to name a few.

C. Factor 2: Economic, Housing, and Demographic Conditions: Single-Family Mortgage Market

This section discusses economic, housing, and demographic conditions that affect the single-family mortgage market. After a review of housing trends and underlying demographic conditions that influence homeownership, the discussion focuses on specific issues related to the single-family owner mortgage market. This subsection includes descriptions of recent market interest rate trends, refinance and home purchase activity, homebuyer characteristics, and the state of affordable lending. Other special topics examined include the growth in subprime lending, the increased use of automated underwriting, and the remaining homeownership potential among existing renters. Section D follows with a discussion of the economic, housing, and demographic conditions affecting the mortgage market for multifamily rental properties.

1. Recent Trends in the Housing Market

While most other sectors of the economy were weak or declining during 2001 and 2002, the housing sector showed remarkable strength. Again in 2003, the housing market enjoyed an outstanding year. The numbers of single-family permits, starts, completions, new home sales, and existing home sales were record-breaking. Home ownership was also at an all-time high, and mortgage interest rates continued to stay under six percent on average. In addition, the prosperity of the market stimulated GDP, contributing 0.37 percent to its overall growth rate of 3.1 percent. Although the multifamily sector experienced high vacancies and low lease-up rates, the vitality of the single family market was strong enough to result in a spectacular peak in total permits and starts as well as builders' attitudes and housing affordability.[43]

Single-Family Permits, Starts, and Completions. Builders took out 1,440,400 single-family permits in 2003, up 6 percent from 2002. The 2003 level was the highest number of single-family permits ever reported in the 44-year history of this series. Single-family starts totaled 1,498,500 housing units, up 10 percent from 2002, a new single-family record. Construction was completed on 1,386,200 single-family housing units, up 5 percent from 2002.

Sales of New and Existing Homes. After leveling out in 2000, housing sales have boomed in the past three years, reaching record highs in 2001, 2002, and again in 2003. New single family home sales, which increased an average 6.3 percent per year between 1992 and 2002, reached a record high of 1,085,000 units in 2003, an increase of 12 percent over 2002 sales. The market for new homes has been strong in the Mid Atlantic, Midwest and Great Plains.

The National Association of Realtors reported that 6.1 million existing homes were sold in 2003, overturning the old record set in 2002 by almost 9 percent, and setting an all-time high in the 35-year history of the series. Combined new and existing home sales set a national record of 6.2 million in 2002 and a record of almost 7.2 million in 2003.

One of the strongest sectors of the housing market in past years had been manufactured homes, but that sector has declined recently. Between 1991 and 1996, manufactured home shipments more than doubled, peaking in 1998 at 373,000. However, shipments fell more than 20 percent in both 2000 and 2001. In 2002, the industry shipped 169,000 new manufactured homes, down 12.4 percent from 2001. This was the lowest number of manufactured home shipments since 1963. In 2003, the number of new manufactured homes shipped plummeted to 131,000, down 22.5 percent from 2002. Repossession has been cited as a cause for the sales drop-off, as has the popularity of conventional stick-built housing.

Homeownership Rate. In 1980, 65.6 percent of Americans owned their own home, but due to the unsettled economic conditions of the 1980s, this share fell to 63.8 percent by 1989. But since 1994, gains in the homeownership rate have occurred in each year, with the rate reaching another record mark of 68.3 percent in 2003.

Gains in homeownership have been widespread over the last eight years.[44] As a result, the homeownership rate rose from:

- 42.0 percent in 1993 to 48.8 percent in 2003 for African American households,
- 39.4 percent in 1993 to 46.7 percent in 2003 for Hispanic households,
- 73.7 percent in 1993 to 79.1 percent in 2003 for married couples with children,
- 65.1 percent in 1993 to 68.4 percent in 2003 for household heads aged 35–44, and
- 48.9 percent in 1993 to 52.3 percent in 2003 for central city residents.

However, as these figures demonstrate, sizable gaps in homeownership remain.

Economy/Housing Market Prospects. Job growth has been less robust in the recent recovery than some previous recoveries. However, the economy grew at a rate of 2.2 percent in 2002 and even faster in 2003.[45] Although the Federal Reserve has recently begun raising short term interest rates, mortgage interest rates remain low, supporting housing affordability.

Fannie Mae expects existing home sales to reach 5.7 million in 2004 and 2005.[46] Projected at 1.84 million in 2003, the National Association of Home Builders expects housing starts to decline to 1.77 million in 2004 and 1.71 million in 2005.[47] The Mortgage Bankers Association forecasts that 2004 housing starts will total 1.73 million units and the 30-year fixed mortgage

[43] US Housing Market Conditions, 4th Quarter, 2003. HUD Office of Policy Development and Research.

[44] Homeownership rates prior to 1993 are not strictly comparable with those beginning in 1993 because of a change in weights from the 1980 Census to the 1990 Census.

[45] National Association of Realtors, ''Near Record Homes Sales Projected for 2003,'' December 3, 2002.

[46] Fannie Mae, ''Berson's Economic and Mortgage Market Development Outlook,'' December 2003. *http://www.fanniemae.com/media/pdf/berson/monthly/2003/121203.pdf.*

[47] *http://www.nahb.org.*

rate will average 6.1 percent.[48] After more than doubling from a relative trough in 2000 to an estimated $2.6 trillion in 2002, Fannie Mae projected in December 2003 that mortgage originations will drop to $1.8 trillion in 2004 and $1.5 trillion in 2005.[49]

2. Underlying Demographic Conditions

Between 2000 and 2025, the U.S. population is expected to grow by an average of 2.5 million per year.[50] This will likely result in at least 1.1 million new households per year.[51] Recently revised increases in population projections by the Census Bureau push population figures higher with the Joint Center estimating new household growth at 13.3 million from 2005 to 2015.[52] This section discusses important demographic trends behind these overall household numbers that will likely affect housing demand in the future. These demographic forces include the baby-boom, baby-bust and echo baby-boom cycles; immigration trends; non-traditional and single households; ''trade-up buyers;'' and the growing income inequality between people with different levels of education. HUD's Office of Policy Development and Research funded a study, *Issue Papers on Demographic Trends Important to Housing,* which analyzes effects of demographic conditions on the housing market. The findings are presented throughout the sections that follow.[53]

As explained below, the role of traditional first-time homebuyers, 25-to-34-year-old married couples, in the housing market will be smaller in the current decade due to the aging of the population. For the first time in history, the population will have roughly equal numbers of people in every age group. Between 2000 and 2025, the Census Bureau projects that the largest growth in households will occur among householders 65 and over.[54] Thus, an increasing percentage of the population will be past their home buying peak in the next two decades. However, because homeownership rates do not peak until population groups reach 65 to 74 years of age, this age cohort will continue to provide housing demand. According to Riche, the increasing presence of older households should increase the proportion of the population that owns, rather than rents housing.[55]

Growing housing demand from immigrants and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. Riche's study estimates that minorities will account for two-thirds of the growth in U.S. households over the next 25 years,[56] and by 2025, non-family households will make up a third of all households. The ''echo baby-boom'' (that is, children of the baby-boomers) will also add to housing demand in the current and next decades. Finally, the growing income inequality between people with and without a post-secondary education will continue to affect the housing market.

The Baby-Boom Effect. The demand for housing during the 1980s and 1990s was driven, in large part, by the coming of home buying age of the baby-boom generation, those born between 1945 and 1964. Homeownership rates for the oldest of the baby-boom generation, those born in the 1940s, rival those of the generation born in the 1930s. Due to significant house price appreciation in the late-1970s and 1980s, older baby-boomers have seen significant gains in their home equity and subsequently have been able to afford larger, more expensive homes. Circumstances were not so favorable for the middle baby-boomers. Housing was not very affordable during the 1980s, their peak home buying age period. As a result, the homeownership rate, as well as wealth accumulation, for the group of people born in the 1950s lags that of the generations before them.[57]

As the youngest of the baby-boomers (those born in the 1960s) reached their peak home buying years in the 1990s, housing became more affordable. While this cohort has achieved a homeownership rate equal to the middle baby-boomers, they live in larger, more expensive homes. As the baby-boom generation ages, demand for housing from this group is expected to wind down.[58]

The baby-boom generation was followed by the baby-bust generation, from 1965 through 1977. Since this population cohort is smaller than that of the baby boom generation, it reduced housing demand in the preceding decade and is expected to do the same in the current decade, though, as discussed below, other factors kept the housing market very strong in the 1990s. However, the echo baby-boom generation (the children of the baby-boomers, who were born after 1977), while smaller than the baby-boom generation, will reach peak home buying age later in the first decade of the millennium.

Immigrant Homebuyers. Past, present, and future immigration will also contribute to gains in the homeownership rate. During the 1990s, 9.8 million legal immigrants entered the United States, as compared to 6.3 million entering in the 1980s and 4.2 million during the 1970s. Overall, the increase in the immigrant population directly accounted for 35 percent of the nation's rise in population in the 1990s.[59] As a result, the foreign-born population of the United States more than tripled from 9.6 million in 1970 to 31.1 million in 2000. Immigrants who become citizens buy homes at rates nearly as high as their same-aged native-born counterparts and for those aged 25 to 34, the gap is virtually nonexistent.[60] Moreover, U.S.-born children of immigrants often have higher homeownership rates than the same-age children of native-born parents.[61] However, there are concerns about the assimilation into homeownership of recent Hispanic immigrants who are less educated than earlier cohorts of immigrants. Many immigrants also locate in high-priced housing markets, which makes it more difficult for them to achieve homeownership.

Although net foreign immigration is projected to decline in the current decade after 2002, high levels of immigration in the late 1980s and throughout the 1990s will have lasting positive effects on housing demand. New immigration in the current and next decades is projected to create 6.9 million net new households, but the majority of household growth in the period (16.9 million) will come from people already resident in the U.S. including the foreign-born population.[62] While immigrants tend to rent their first homes upon arriving in the United States, homeownership rates are substantial for those that have lived here for at least 6 years. In 1996, the homeownership rate for recent immigrants was 14.7 percent while it was 66.9 percent for foreign-born naturalized citizens after six years.[63] Higher-than-average foreign-born fertility rates and high rates of homeownership for immigrants living in the country for several years and among the children of immigrants suggest that past immigration will continue to create housing demand.

Past and future immigration will lead to increasing racial and ethnic diversity, especially among the young adult

[48] Mortgage Bankers Association of America, Mortgage Finance Forecast, December 17, 2003. *http://www.mbaa.org/marketdata/forecasts/mffore1103.pdf.*

[49] Fannie Mae, ''Berson's Economic and Mortgage Market Development Outlook,'' December 2003.

[50] U.S. Census Bureau, Population Projections Table NP–T1.

[51] Martha Farnsworth Riche, ''How Changes in the Nation's Age and Household Structure Will Reshape Housing Demand in the 21st Century,'' in *Issue Papers on Demographic Trends Important to Housing,* Urban Institute Final Report to the Office of Policy Development and Research, U.S. Department of Housing and Urban Development, September 2002, p. 5.

[52] Joint Center for Housing Studies at Harvard University, *State of the Nation's Housing 2004*, p.10–11.

[53] Barry Chiswick, Paul Miller, George Masnick, Zhu Xiao Di, and Martha Farnsworth Riche, *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the Office of Policy Development and Research, U.S. Department of Housing and Urban Development, September 2002.

[54] Martha Farnsworth Riche, ''How Changes in the Nation's Age and Household Structure Will Reshape Housing Demand in the 21st Century,'' in *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the U.S. Department of Housing and Urban Development, September 2002, p. 4.

[55] *Ibid.* p. 6.

[56] The National Association of Homebuilders estimates base housing demand will average 1.84 million units but increases that estimate to 2.19 million units with high immigration.

[57] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998*, p. 14.

[58] *Ibid.* p. 15.

[59] Federation for American Immigration Reform, <*http://www.fairus.org/html/042us604.htm#ins*>, site visited December 13, 2002.

[60] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2004,* p. 11–12.

[61] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2002,* pp. 16–17.

[62] George S. Masnick and Zhu Xiao Di, ''Projections of U.S. Households By Race/Hispanic Origin, Age, Family, Type, and Tenure to 2020: A Sensitivity Analysis,'' in *Issue Papers on Demographic Trends Important to Housing.* Urban Institute Final Report to the U.S. Department of Housing and Urban Development, September 2002, p. 5.

[63] Fred Flick and Kate Anderson, ''Future of Housing Demand: Special Markets,'' *Real Estate Outlook,* 1998, p. 6.

population. As immigrant minorities account for a growing share of first-time homebuyers in many markets, HUD and others will have to intensify their focus on removing discrimination from the housing and mortgage finance systems. The need to meet nontraditional credit needs, respond to diverse housing preferences, and overcome the information barriers that many immigrants face will take on added importance. In order to address these needs, the mortgage industry must offer innovative products and improve outreach efforts to attract minority homebuyers.

Nontraditional and Single Homebuyers. While overall growth in new households has slowed down, nontraditional households have become more important in the homebuyer market. As the population ages both relatively and absolutely, the nation's households will become smaller and more diverse. Riche notes that in 2000, traditional family households represented fewer than one in four households and were surpassed by both single-person households and married couples without children. With later marriages and more divorces, single-parent and single-person households have increased rapidly. In fact, single-parent households grew from 4 percent of family households in 1950 to 12 percent in 2000. Single-person households are now the nation's second most numerous household type, accounting for over 25 percent of all households. In the future, longer life expectancies and the continuing preference for one or two children will make households without children even more numerous. Projected to compose 80 percent of all households by 2025, nontraditional family households will play an increasingly important role in the home buying market.[64]

Trade-up Buyers. Due to weak house price appreciation, traditional ''trade-up buyers'' stayed out of the market during the early 1990s. Their absence may explain, in part, the large representation of nontraditional homebuyers during that period. However, since 1995 home prices have increased more than 30 percent.[65] The greater equity resulting from recent increases in home prices should lead to a larger role for ''trade-up buyers'' in the housing market during the next 10 to 15 years. In addition, the growing number of higher-income, mid-life households will increase households' potential to ''trade up'' to more expensive housing.[66]

Growing Income Inequality. The Census Bureau reported that the top 5 percent of American households received 22.4 percent of aggregate household income in 2001, up from 21.4 percent in 1998 and up sharply from 16.1 percent in 1977. The share accruing to the lowest 80 percent of households fell from 56.5 percent in 1977 to 50.8 percent in 1998 and again to 49.8 percent in 2001. The share of aggregate income accruing to households between the 80th and 95th percentiles of the income distribution was virtually unchanged from 1977 to 2001.[67]

The increase in income inequality over past decades has been especially significant between those with and those without post-secondary education. The Census Bureau reports that by 1999, the annual earnings of workers with a bachelor's degree were 1.8 times the annual earnings of workers with a high school education.[68] The inflation-adjusted median earnings of high school graduates were at the same level in 2001 as in 1991 while the earnings of bachelor degree-holders rose nearly 9 percent over the same period.[69]

So, while homeownership is highly affordable, those without post-secondary education often lack the financial resources to take advantage of the opportunity. As discussed earlier, the days of the well-paying unionized factory job have passed. They have given way to technological change that favors white-collar jobs requiring college degrees, and wages in the manufacturing jobs that remain are experiencing downward pressures from economic globalization. The effect of this is that workers without the benefit of a post-secondary education find their demand for housing constrained. This is especially problematic for recent immigrants who are more likely to have limited educational attainment and English language proficiency.

Summary. Over the next two-and-a-half decades, the number of U.S. households is projected to increase by nearly 27 million. Of these new households, non-Hispanic white and traditional households will contribute only one-third and one-tenth of the growth, respectively. As the baby-boomers aged out of their peak home buying stage and the baby-bust generation aged into their peak home buying stage in the late 1980s, demand for housing was dampened by demographic factors during the 1990s. (Of course, other factors such as low interest rates propelled the housing market to record levels during this period.) As the echo baby-boomers begin to enter their peak home buying age, housing demand should pick up again through the remainder of the current decade and into the next. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new homeowners. There are continuing concerns about the increasing income inequality of our population and those recent immigrants and other persons who have limited education.

3. Basic Trends in the Single-Family Mortgage Market

Mortgage lending in the nation is growing at unprecedented levels. Residential mortgage originations soared to $2.5 trillion in 2002, a 22 percent increase over the previous record of $2.06 trillion set in 2001.[70] Originations then jumped to $3.8 trillion in 2003, with refinances accounting for 66 percent (or $2.5 trillion) of this total.

This boom in lending over the past three years can be attributed to low mortgage interest rates and a record number of refinances. Approximately 40 percent of mortgage debt outstanding, or $2.5 trillion, was refinanced during the 2001–02 refinance boom. Freddie Mac calculates total home equity cashed out in 2002 at 105.4 billion and estimates that number will increase to 138.8 billion in 2003.[71] This section focuses on recent interest rate trends, the refinance market, the home purchase market, and first-time homebuyers. The section concludes by examining the GSEs' acquisitions as a share of the primary single-family mortgage market, and provides mortgage market prospects.

a. Mortgage Characteristics

Interest Rate Trends and Volatility. Historically low mortgage interest rates in the late 1990s and 2001–2003 helped maintain consumer confidence in the housing sector as the economy emerged from its first recession in almost a decade. After high and fluctuating mortgage rates in the 1980s and early 1990s, recent years have seen a period of lower and more stable rates. The 1980s began with interest rates on mortgages for new homes above 12 percent but quickly rose to more than 15 percent.[72] By 1987–88, rates dipped into single digits but were rising again by 1989–90. Rates declined in the early 1990s, reaching a low of 6.8 percent in late 1993. An upturn in rates in 1994 and 1995 peaked at 8.3 percent in early 1995. By 1998, 30-year fixed conventional mortgages averaged 6.95 percent, the lowest level since 1968 but saw a rise in 1999 to 7.44 percent. Mortgage rates then continued to rise in 2000, averaging 8.05 percent for the year, before falling to a low of 6.62 percent in October 2001 and averaging 6.97 percent for 2001 as a whole.[73] Rates averaged 5.83 percent during 2003 [74], reaching a low of 5.23 in June. Rates in 2004 have averaged 5.83 through August, reaching a low of 5.45 in March. [75]

Other Loan Terms. When mortgage rates are low, most homebuyers prefer to lock in a fixed-rate mortgage (FRM). Adjustable-rate mortgages (ARMs) are more attractive when

[64] Riche, 2002, p. 1.

[65] Average new-home price: U.S. Census Bureau, <*http://www.census.gov/const/uspriceann.pdf*>.

[66] Riche, 2002, p. 17.

[67] All data in this paragraph are from the U.S. Census Bureau's Historical Income Table H2.

[68] Jennifer Cheeseman Day and Eric C. Newburger, *The Big Payoff: Educational Attainment and Synthetic Estimates of Work-Life Earnings,* U.S. Bureau of the Census, Current Population Reports P23–210, July 2002, p. 3.

[69] U.S. Census Bureau, Historical Income Table H13.

[70] ''Mortgage Originations Hit Record-Busting $2.5 Trillion in 2002, IMF Numbers Reveal,'' *Inside Mortgage Finance,* January 24, 2003, p. 3.

[71] Freddie Mac ''Cash-Out Refi Report.''

[72] Interest rates in this section are effective rates paid on conventional home purchase mortgages on new homes, based on the Monthly Interest Rate Survey (MIRS) conducted by the Federal Housing Finance Board and published by the Council of Economic Advisers annually in the *Economic Report of the President* and monthly in *Economic Indicators.* These are average rates for all loan types, encompassing 30-year and 15-year fixed-rate mortgages and adjustable rate mortgages.

[73] *U.S. Housing Market Conditions, 2nd Quarter 2002,* August 2002, Table 14.

[74] *U.S. Housing Market Conditions, 4th Quarter 2003,* February 2004, pg.1.

[75] Mortgage Bankers Association website. MBA Weekly Survey of Mortgage Applications, Monthly Average Interest Rates On 30-Year Fixed-Rate Mortgages. *http://www.mortgagebankers.org/marketdata/index.html.*

rates are high, because they carry lower rates than FRMs and because buyers may hope to refinance to an FRM when mortgage rates decline. The Federal Housing Finance Board (FHFB) reports that the ARM share of the market fell from 20 percent in 1993 to a record low of 12 percent in 1998, before rising back to 21 percent in 1999. The ARM share continued to rise to 24 percent in 2000, but then fell dramatically to a low of 12 percent in 2001 as mortgage rates decreased. However, in 2002 and 2003, there was a rebound in the ARM share of the market. Though it still is nowhere near the size it was in the mid to late 1990s, the past two years have seen the share climb to 17 and 19 percent, respectively.[76]

In 2003, the term-to-maturity was 30 years for 80 percent of conventional home purchase mortgages, continuing to decline after steadily climbing to a high of 90 percent in 2000. The other major term of maturity in 2003 was 15 years (16 percent).[77]

Low- and no-point mortgages continue to be a popular option for mortgage purchases. FHFB reports that average initial fees and charges (''points'') have decreased from 2.5 percent of loan balance in the mid-1980s to 2 percent in the late-1980s, 1.5 percent in the early 1990s, and less than 1 percent in 1995–97. The downward trend continued throughout the late 1990s with the average initial fees and charges reaching a low of one-half percent in 2001, staying there in 2002, and dipping even further down in 2003. Coupled with declining interest rates, these lower transactions costs have increased the propensity of homeowners to refinance their mortgages.[78]

Another major change in the conventional home mortgage market has been the proliferation and then diminution of high loan-to-value ratio (LTV) mortgages. According to data from the Federal Housing Finance Board, loans with LTVs greater than 90 percent (that is, down payments of less than 10 percent) made up less than 10 percent of the market in 1989–91, but 25 percent of the market in 1994–97, gradually decreasing to an average of 20 percent of the market in 2003. Loans with LTVs less than or equal to 80 percent fell from three-quarters of the market in 1989–91 to an average of 56 percent of the market in 1994–97, but then rose to an average of 63 percent of mortgages originated in 1998–2001, and rose again to an average of 70 percent of mortgages originated in 2002–2003.[79] As a result, the average LTV rose from 75 percent in 1989–91 to nearly 80 percent in 1994–97, and then declined to 76.2 percent in 2001, 75.1 percent in 2002, and 73.5 percent in 2003.[80]

b. Refinance Mortgages

Over the past ten years, refinance booms occurred three times, during 1992–93, 1998, and 2001–03. Refinancing has fueled the growth in total mortgage originations, which were $638 billion in 1995 (a period of low refinance activity), but topped $2.5 trillion in 2002 (a period of heavy refinance activity). The refinance share of total mortgage originations rose to 50 percent in 1998, then decreased to 19 percent in 2000 before jumping to 57 percent in 2001, and 59 percent in 2002. During the 2001–02 refinance boom, approximately 40 percent of the $2.5 trillion in mortgage debt outstanding was refinanced. In 2003, the refinance share of total mortgage originations hit 66 percent, though late 2003 saw a steep drop-off from a 68 percent share in the third quarter to a 49 percent share in the fourth.[81]

In 1989–90 interest rates exceeded 10 percent, and refinancings accounted for less than 25 percent of total mortgage originations.[82] The subsequent sharp decline in mortgage rates drove the refinance share over 50 percent in 1992 and 1993 and propelled total single-family originations to more than $1 trillion in 1993—twice the level attained just three years earlier.

The refinance wave subsided after 1993, because most homeowners who found it beneficial to refinance had already done so and because mortgage rates rose once again.[83] Total single-family mortgage originations bottomed out at $638 billion in 1995, when the refinance share was only 21 percent. Total originations, driven by the volume of refinancings, amounted to $1.507 trillion in 1998, nearly 50 percent higher than the previous record level of $1.02 trillion attained in 1993.

The refinance wave from late 1997 through early 1999 reflected other factors besides interest rates, including greater borrower awareness of the benefits of refinancing, a highly competitive mortgage market, and the enhanced ability of the mortgage industry, utilizing automated underwriting and mortgage origination systems to handle an unprecedented volume of originations. The refinance share decreased to 19 percent in 2000 before jumping to a record 57 percent in 2001.

Historically low interest rates and declining mortgage transaction costs have driven the latest refinancing boom. Given these conditions, the after-tax cost saving on a new, lower-rate loan is much greater than the transaction costs of refinancing. In addition, the appreciation of housing prices has also contributed to the increase in refinancing. Over the past five years, the value of housing rose by approximately $5 trillion, and the rise in value has enabled lenders to service refinancing homeowners because of greater confidence in the creditworthiness of borrowers.[84]

Over the past few years, homeowners have become more willing to draw on the rising equity in their homes. According to Fannie Mae's 2002 National Housing Survey, homeowners that refinanced during 2001 withdrew about $110 billion in accumulated home equity wealth.[85] Freddie Mac estimates that more than one-half of all refinance mortgages in the past two years involved cash-out refinancing.[86]

The refinancing boom contributed to an estimated one-fifth of the national economy's real GDP growth since late 2000.[87] During 2001 and 2002, roughly $270 billion was raised in cash-out refinancing. Approximately one-half of cash from cash-out refinancing has enabled consumers to finance more spending for expenses such as home improvements, medical payments, education, and vehicles during a weakened economy. Roughly one-third of the cash from cash-out refinancing has allowed consumers to repay other debt.[88] The remaining cash from cash-out refinancing has enabled consumers to invest in other assets. Refinancing households save approximately $10 billion in their annual interest payments on their mortgage and consumer installment liabilities.

The refinancing boom will have lingering effects. Mortgage borrowers that were able to secure low long-term interest rates through fixed rate mortgages will have more of their budgets to spend on other items. Meanwhile, cash-out borrowers, who are just receiving their money, will spend this year. It must be noted there is some concern regarding the potential for increased credit risk stemming from mortgage debt from cash out borrowers. According to a 2002 Regional Finance Review article, the mortgage liabilities of households have been growing at a rate more than double the growth in household incomes. However, this potential credit risk is moderated by the strong growth in housing values. The ratio of mortgage debt to housing

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[76] *http://www.fhfb.gov/mirs/mirs_t25.xls.*

[77] *http://www.fhfb.gov/mirs/mirstbl5.xls;* data for 2003 is average of May through December data.

[78] This is discussed in more detail in Paul Bennett, Richard Peach, and Stavros Peristani, *Structural Change in the Mortgage Market and the Propensity to Refinance,* Staff Report Number 45, Federal Reserve Bank of New York, September 1998.

[79] *http://www.fhfb.gov/mirs/mirs_t1.xls.*

[80] Other sources of data on loan-to-value ratios such as the American Housing Survey and the Chicago Title and Trust Company indicate that high-LTV mortgages are somewhat more common in the primary market than the Finance Board's survey. However, the Chicago Title survey does not separate FHA-insured loans from conventional mortgages. In addition, the statistics cited above pertain only to home purchase mortgages. Refinance mortgages generally have shorter terms and lower loan-to-value ratios than home purchase mortgages.

[81] The source for the refinance share and total mortgage originations is the Mortgage Bankers Association (*http://www.mortgagebankers.org/marketdata/forecasts/mffore1203.pdf, http://www.mortgagebankers.org/marketdata/forecasts/ffJUNE2004.pdf).*

[82] Refinancing data is taken from Freddie Mac's monthly *Primary Mortgage Market Survey.*

[83] There is some evidence that lower-income borrowers did not participate in the 1993 refinance boom as much as higher-income borrowers—see Paul B. Manchester, *Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac: 1996–97 Update,* Housing Finance Working Paper No. HF–006, Office of Policy Development and Research, Department of Housing and Urban Development, August 1998, pp. 30–32.

[84] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 4.

[85] Fannie Mae, *2002 Fannie Mae National Housing Survey. <http://www.fanniemae.com/global/pdf/media/survey/survey2002>,* September 4, 2002, p. 2.

[86] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 4.

[87] Mark M. Zandi, ''Refinancing Boom,'' *Regional Finance Review,* December 2002, p. 11.

[88] *Ibid.* p. 14.

values, the aggregate loan-to-value ratio, has remained fairly stable for a decade.[89]

c. Home Purchase Mortgages

The volume of home purchase mortgages was $505 billion in 1995, rose to $848 billion in 1999, and remained in the $829–$873 billion range between 1999–2001 before jumping to $1.02 trillion in 2002 and $1.30 trillion in 2003. The Mortgage Bankers Association (MBA) forecasts that the home purchase volume will be $1.52 trillion in 2004 as the home purchase share rises to 57 percent of all originations.[90] The home purchase share of total mortgage originations was 79 percent in 1995, declined to 50 percent in 1998, rose to 81 in 2000, and sharply fell to 43 percent in 2001, 41 in 2002, and 34 percent in 2003, as refinance mortgage volume grew. This section discusses the important issue of housing affordability and then examines the value of homeownership as an investment.

The National Association of Realtors (NAR) has developed a housing affordability index, calculated as the ratio of median household income to the income needed to qualify for a median price home (the latter income is called the ''qualifying income''). In 1993, NAR's affordability index was 133, which meant that the median family income of $37,000 was 33 percent higher than that income needed to qualify for the median priced home. Housing affordability remained at about 130 for 1994–97, with home price increases and somewhat higher mortgage rates being offset by gains in median family income.[91] Falling interest rates and higher income led to an increase in affordability to 143 in 1998, reflecting the most affordable housing in 25 years. Affordability remained high in 1999, despite the increase in mortgage rates. NAR's affordability index declined from 140 in 1999 to 129 in 2000 as mortgage rates increased. The index turned upward to 136 in 2001 as mortgage rates fell and maintained this average in 2002, before rising further to 140 in 2003.[92]

Although the share of home purchase loans for lower-income households and/or households living in lower-income communities increased over the past decade, affordability still remains a challenge for many. The median sales price of existing single-family homes in the United States continues to rise, reaching $158,100 in 2002 and $170,000 in 2003. The production of affordable housing and low interest rates could offset the negative impact of rising house prices, which undermine housing affordability for many Americans, particularly in several high-cost markets on the east and west coasts.

As discussed earlier, barriers are preventing many potential homeowners from becoming homeowners, thus reducing the possible amount of home purchase loans. While the strong housing sector has provided financial security for many Americans, a 2002 Fannie Mae survey found that ''information barriers still keep many financially qualified families-particularly minority Americans from becoming homeowners or obtaining the lowest-cost financing available to them.'' [93]

These homeownership barriers pose a serious problem for many Americans who view homeownership as a smart, safe, long-term investment, rating homeownership as a better investment than the stock market. Home equity is the single most important asset for approximately two-thirds of American households that are homeowners. Considering that half of all homeowners held at least 50 percent of their net wealth in home equity in 1998, increasing housing affordability is important for many Americans.[94]

First-time Homebuyers. First-time homebuyers are a driving force in the nation's mortgage market. The recent low interest rates have made it an opportune time for first-time homebuyers, which are typically people in the 25–34 year-old age group that purchase modestly priced houses. As the post-World War II baby boom generation ages, the percentage of Americans in this age group decreased from 28.3 percent in 1980 to 25.4 percent in 1992.[95] Even though this cohort is smaller, first-time homebuyers increased their share of home sales. According to Chicago Title data for major metropolitan areas, the first-time buyer share of the homebuyer market increased from roughly 40 percent in the beginning of the 1990s to 45–47 percent during the-mid and late 1990s.[96] Since the late 1990s, industry survey data suggest that the first-time homebuyer percentage has decreased slightly. In the first quarter of 2003, the share of all home purchases by first-time homebuyers was 40 percent compared to 42 percent in 2001.[97]

In the 1990s, lenders developed special programs targeted to first-time homebuyers and revised their underwriting standards to enhance homeownership opportunities for low-income families with special circumstances. The disproportionate growth in the number of first-time homebuyers and minority homebuyers largely drove the rising trend in total home purchases. Analysis of the American Housing Survey (AHS) indicates there were 1.3 million new first-time homebuyers during 1991, in comparison with over two million in each year between 1996 and 2001. In addition, first-time homebuyers comprised approximately 60 percent of all minority home purchases during the 1990s, compared with about 35 percent of all home purchases by non-Hispanic white families.

In comparison to repeat homebuyers, first-time homebuyers are more likely to be younger, have lower incomes, and purchase less expensive houses. According to the AHS, more than one-half or first-time homebuyers were below the age of 35, compared with less than one-quarter of repeat buyers in the 1990s. Thirty-nine percent of first-time buyers had incomes below 80 percent of the median compared to 30 percent of repeat buyers. Fifty-four percent of first-time buyers purchased homes priced below $100,000, compared to 37 percent of repeat buyers. Minorities comprise a higher proportion of first-time buyers (32 percent) compared to repeat buyers (14 percent). Compared to repeat buyers, first-time homebuyers are more likely to purchase a home in the central city and more likely to be a female-headed household.[98]

The National Association of Realtors reports that the average first-time homebuyer in the first quarter of 2003 was 32 years old with a household income of $54,800, compared to an average age of 46 years and average household income of $74,600 for repeat buyers. The average first-time homebuyers made a downpayment of 6 percent on a home that cost $136,000 while the average repeat buyer made a downpayment of 23 percent on a home costing $189,000. In the NAR survey, 37 percent of first-time homebuyers were single compared to 28 percent of repeat buyers.[99]

Many African Americans and Hispanics are likely to purchase homes in the coming years, contributing to the number of first-time home-buyers fueling growth in the housing sector. The number of homeowners will rise by an average of 1.1 million annually over the next two decades. The sizeable rise in the foreign-born population since the 1970's coupled with the increase in Latin American and Asian immigration will also contribute much to this growth.[100]

d. GSEs' Acquisitions as a Share of the Primary Single-Family Mortgage Market

Purchases by the GSEs of single-family mortgages amounted to $519 billion during the heavy refinancing year of 1993, stood at $215 billion in 1995, and were at $618 billion during the heavy refinancing year of 1998. Purchases then fell to $395 billion in 2000 before reaching record levels during the heavy refinancing years of 2001 ($961 billion) and 2002 ($1,090 billion). Purchases by Fannie Mae decreased from $316 billion in 1999 to $227 billion in 2000, before rising to $568 billion in 2001, $800 billion in 2002, and $1.3 trillion in 2003. Freddie Mac's

[89] Economy.com, ''The Economic Contribution of the Mortgage Refinancing Boom,'' December 2002, p. 9.

[90] Mortgage Bankers Association, ''Mortgage Finance Forecast'', September 17, 2004. *http://www.mortgagebankers.org/marketdata/forecasts/mffore1203.pdf.*

[91] Housing affordability varies markedly between regions, ranging in January 2004 from 194 in the Midwest to 107 in the West, with the South and Northeast falling in between.

[92] National Association of REALTORS. Housing Affordability Index, *<http://www.realtor.org/Research.nsf/Pages/HousingInx>*, 2003.

[93] Fannie Mae, September 4, 2002, p.2.

[94] *Ibid.*

[95] U.S. Department of Commerce, Bureau of the Census, *Money Income of Households, Families, and Persons in the United States: 1992,* Special Studies Series P–60, No. 184, Table B–25, October 1993.

[96] Chicago Title and Trust Family of Insurers, *Who's Buying Homes in America,* 1998.

[97] National Association of Realtors. ''New NAR Survey of Home Buyers and Sellers Shows Growing Web Use in a Dynamic Housing Market.'' *http://www.realtor.org.*

[98] *U.S. Housing Market Conditions, 3rd Quarter 2001,* November 2001, Table 4.

[99] National Association of Realtors. ''New NAR Survey of Home Buyers and Sellers Shows Growing Web Use in a Dynamic Housing Market.'' *http://www.realtor.org.*

[100] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2002,* p. 2.

single-family mortgage purchases followed a similar trend, falling from $233 billion in 1999 to $168 billion in 2000, and then rising to $393 billion in 2001 and $475 billion in 2002.[101]

The Office of Federal Housing Enterprise Oversight (OFHEO) estimates that the GSEs' share of total originations in the conventional single-family mortgage market, measured in dollars, declined from 37 percent in 1996 to 32 percent in 1997—well below the peak of 51 percent attained in 1993. OFHEO attributes the 1997 downturn in the GSEs' role to increased holdings of mortgages in portfolio by depository institutions and to increased competition with Fannie Mae and Freddie Mac by private label issuers. However, OFHEO estimates that the GSEs' share of the conventional market rebounded sharply in 1998–99, to 43–42 percent. The GSEs' share then decreased to approximately 30 percent of the single-family conventional mortgages originated in 2000, and then increased sharply to 40 percent in 2001. Total GSE purchases, including loans originated in prior years, amounted to 46 percent of conventional originations in 2001[102] and approximately 38 percent of family home mortgage originations in 2002.[103]

e. Mortgage Market Prospects

The Mortgage Bankers Association (MBA) reports that mortgage originations in 2001 were $2.0 trillion, which is almost twice the volume of originations in 2000. Mortgage originations then increased to record levels of $2.5 trillion in 2002 and $3.8 trillion in 2003, with refinancings representing 66 percent of originations and the purchase volume amounting to $1.3 trillion. Estimates indicate that ARMs accounted for 19 percent of total mortgage originations in 2003.[104] In its September 17, 2004 forecast, MBA predicts that single-family mortgage originations will amount to $2.7 trillion in 2004 and $1.8 trillion in 2005, with refinancings representing 43 percent and 25 percent of originations respectively.

4. Affordable Lending in the Mortgage Market: New Products and Outreach

Extending homeownership opportunities to historically underserved households has been a growing concern for conventional lenders, private mortgage insurers and the GSEs. The industry has responded in what some have called a ''revolution in affordable lending''. The industry has offered more customized mortgage products, more flexible underwriting, and expanded outreach so that the benefits of the mortgage market can be extended to those who have not been adequately served through traditional products, underwriting, and marketing.

Fannie Mae and Freddie Mac have been a part of this ''revolution in affordable lending''. During the mid-to-late 1990s, they added flexibility to their purchase guidelines, they introduced new low-down-payment products, and they worked to expand the use of credit scores and automated underwriting in evaluating the creditworthiness of loan applicants. These major trends reflect changes in the GSEs' underwriting that have impacted affordable lending. Through these trends, Fannie Mae and Freddie Mac have attempted to increase their capacity to serve low- and moderate-income homebuyers.

This section summarizes recent initiatives undertaken by the GSEs and others in the industry to expand affordable housing. The end of this section will present evidence that these new industry initiatives are working, as increased mortgage credit has been flowing to low-income and minority families. The following section will continue the affordable lending theme by examining the performance of different market sectors (*e.g.*, depositories, GSEs, etc.) in funding loans for low-income and minority families. That section will also discuss the important role that FHA plays in making affordable housing available to historically underserved groups as well as the continuing concern that participants in the conventional market could be doing even more to help underserved families.

a. Lowering Down Payments and Up-Front Costs

Numerous studies have concluded that saving enough cash for a down payment and for up-front closing costs is the greatest barrier that low-income and minority families face when considering homeownership.[105] To assist in overcoming this barrier, the industry (including lenders, private mortgage insurers and the GSEs) began offering in 1994 mortgage products that required down payments of only 3 percent, plus points and closing costs. Other industry efforts to reduce borrowers' up-front costs included zero-point-interest-rate mortgages and monthly insurance premiums with no up front component. These new plans eliminated large up-front points and premiums normally required at closing.

During 1998, Fannie Mae introduced its ''Flexible 97'' and Freddie Mac introduced its ''Alt 97'' low down payment lending programs. Under these programs, borrowers were required to put down only 3 percent of the purchase price. The down payment, as well as closing costs, could be obtained from a variety of sources, including gifts, grants or loans from a family member, the government, a non-profit agency and loans secured by life insurance policies, retirement accounts or other assets. Fannie Mae continues to offer the ''Flexible'' line of products, and Freddie Mac continues to list ''Alt 97.''

In 2000, Fannie Mae launched the ''MyCommunityMortgage'' suite of products, which provides high loan-to-value product options for low- and moderate-income borrowers. In 2003, Fannie Mae purchased or securitized more than $2.27 billion of MyCommunityMortgage products, which helped provide affordable housing solutions for 20,400 households. In addition, Fannie Mae enhanced the MyCommunityMortgage to help lenders further expand affordable financing to underserved families. Examples of these enhancements included adding MyCommunityMortgage to Desktop Underwriter in order to provide lenders easier access to customized CRA-targeted loan products, adding new credit and income flexibilities for borrowers purchasing single family homes, Community HomeChoice which offers more flexible requirements for persons with disabilities, Community 2–4 FamilyTM to help make the purchase of 2–4 unit homes more affordable for first time homebuyers, and Community RenovationTM 1–4 Family Pilot to help borrowers with home improvement and housing preservation costs.[106] Additionally, in 2003, Fannie Mae enhanced Community 2–4 Family and Community Renovation 1–4 Family pilots. This product provides lower down payments and flexible parameters for owner-occupants of 1–4 unit properties.[107]

Fannie Mae also expanded its ''Flexible'' product line with the ''Flexible 100'' product, which eliminates the requirement for a down payment by providing 100 percent loan-to-value financing. The borrower is required to make either a minimum of 3% (of the lesser of the sales price or appraised value) from approved flexible sources or making a minimum contribution of $500 from their own funds. The 3% may come from a variety on sources such as gifts, grants, or unsecured loans from relatives, employers, public agencies, or nonprofits. In 2003, Fannie Mae purchased $13.7 billion in *Flexible* loans that benefited 100,866 households.[108]

Fannie Mae has also developed products specifically geared toward populations with unique needs such as seniors, Native Americans and families living near public transit routes. Examples of these targeted products include the *Home Equity Conversion Mortgage (HECM)* which allows seniors to convert the equity in their homes to receive cash. In 2003, Fannie Mae purchased 27,644 HECM's for a total value of $1.87 billion. *PaymentPower*™ allows borrowers with strong credit to skip their regularly scheduled monthly payment up to two times during a twelve-month period and up to ten times during the life of the loan. This pilot was launched in July 2002 and by year-end 2003, Fannie Mae purchased 963 *PaymentPower*™ mortgages totaling $126 million. *Navajo Community Guaranty Initiative* allows Navajo families to contribute

[101] Office of Federal Housing Enterprise Oversight (OFHEO), *Report to Congress,* 2004, Tables 1 and 11.

[102] Office of Federal Housing Enterprise Oversight. ''Mortgage Markets and The Enterprises in 2001,'' August 2002, p. 13.

[103] *http://www.financialservicesfacts.org/financial2/mortgage/mortgages/?table_sort_734796=4.*

[104] Mortgage market projections from the MBA's *MBA Mortgage Finance Forecast,* December 17, 2003. 2000 and 2001 numbers from the MBA's *MBA Mortgage Finance Forecast, January 10, 2002.*

[105] See Charles, K. K. and E. Hurst (2002). ''The Transition to Home Ownership and the Black-White Wealth Gap.'' *The Review of Economics and Statistics,* 84(2): 281–297; Mayer, C. and G. Engelhardt (1996). ''Gift Down Payments and Housing Affordability.'' *Journal of Housing Research,* 7(1): 59–77; and Quercia, R. G., G. W. McCarthy, *et al.* (2003). ''The Impacts of Affordable Lending Efforts on Homeownership Rates.'' *Journal of Housing Economics,* 12(1): 29–59.

[106] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, pp. 8–9.

[107] Fannie Mae, ''Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac,'' July 16, 2004, p. I–58.

[108] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, p. 6.

a minimum of $500 or 1% of the purchase price, whichever is lower. This initiative, announced in 2003, will provide $3 million in home financing to help 60 families currently living on a reservation. The *Smart Commute*™ Initiative, which targets borrowers purchasing homes near a public transit route, recognizes that homebuyers will save commuting expenses and therefore have more disposable income to pay housing expenses. In 2003 Fannie Mae purchased approximately $5 million in *Smart Commute*™ *Initiative* loans.[109]

In 2000, Freddie Mac introduced its ''Freddie Mac 100'' product, which is designed to assist borrowers who have good credit but lack the ability to provide a large down payment. ''Freddie Mac 100'' allows a 100 percent loan-to-value ratio with the condition that the borrower has the funds for closing costs. In 2003, a refinance option was added to Freddie Mac 100 and the cost of the loan was reduced through lower mortgage insurance coverage and a lower fee for the product. These changes have made the Freddie Mac 100 available to borrowers who may not have been able to take advantage of the refinance boom as a result of low or no equity in their homes.[110]

Another Freddie Mac product, Affordable Gold® 97 permits borrowers to make 3% down payments from personal cash and to use other sources to cover their closing costs, and offers flexible ratio and reserves guidelines. In 2003 this product was enhanced with a refinance option allowing more borrowers to take advantage of the low rates in the market. The Affordable Gold® 100 provides 100 percent financing to low- and moderate-income borrowers for the purchase price of a home in California. Affordable Gold® 100 combines mortgage insurance benefits provided by a state insurance fund, the secondary mortgage market, and a team of the nation's leading mortgage lenders.[111]

Additional Freddie Mac products include the Alt 97℠ for borrowers who have good credit but limited cash for a down payment. In 2003, this product was enhanced with a refinance option and reduced fees. The Two-Family 95 Percent LTV Program offers low down payment loans to purchasers of two-family properties when the borrowers occupy one of the units as their primary residence.[112] Other initiatives include policies aimed at improving the homeownership rate among immigrant families and the Section 8 Rental to Homeownership program, which allows people currently receiving Section 8 rental subsidies to use them toward mortgage payments. [113] Freddie Mac purchases loans in which the borrower's down payment consists of funds that have been matched through an Individual Development Account homebuyer savings program. And in 2003, Freddie Mac provided increased liquidity for affordable housing through a series of targeted investments in Mortgage Revenue Bonds containing state and local housing finance agency mortgages.[114]

b. Partnerships—Fannie Mae

In addition to developing new affordable products, lenders and the GSEs have been entering into partnerships with local governments and nonprofit organizations to increase mortgage access to underserved borrowers. Fannie Mae operates 55 partnership offices throughout the country, including the West Virginia Partnership Office, which opened in 2003. These offices coordinate Fannie Mae's programs with local governments, lenders, public officials, housing organizations, community nonprofits, real estate professionals, and other local stakeholders.[115]

Fannie Mae continues to reach out to national groups and work with local affiliates to expand homeownership. Fannie Mae has established multi-year partnerships to increase affordable housing opportunities with organizations such as: The Enterprise Foundation, The Neighborhood Reinvestment Corporation, ACORN Housing Corporation, The National Council of La Raza, and many others engaged in promoting affordable housing. In 2003, Fannie Mae financed $1.3 billion of mortgages with these national partners and participating lenders, which resulted in 9,597 loans. For example, Fannie Mae maintains a partnership with the National Urban League (NUL) and the JP Morgan Chase Bank to increase NUL's homeownership counseling capacity by providing the necessary technology and tools to support the effort, and to purchase $50 million in mortgage products over five years that are specifically targeted to increase homeownership among minorities. In 2003, approximately $6 million in loans were originated through this initiative. Another example is Fannie Mae's partnership with the AFL-CIO Housing Investment Trust (HIT) and Countrywide Home Loans, which launched ''HIT HOME'' in 2001. HIT HOME is an affordable home mortgage initiative that targets 13 million union members in 35 cities throughout the nation to provide union members with a variety of affordable mortgage choices that enable them to qualify for competitively priced loans with new re-payment terms. In 2003, over $132 million worth of mortgages were originated through this partnership.[116]

In order to meet the needs of underserved and low- and moderate-income populations, Fannie Mae has targeted specific populations for initiatives. These include the Section 8 Homeownership Initiative, which purchased 81 Section 8 loans and funded an additional 55 loans through a Community Development Financial Institution investment; the Native American Homeownership Initiative, which has committed to invest at least $350 million to support homeownership strategies for 4,600 Native American families and to work with 100 tribes; the Minority- and Women-Owned Lenders Initiative, to reach underserved communities and to develop innovative solutions for increasing business opportunities for these lenders; The Employer-Assisted Housing Initiative, designed to assist employers in developing a company benefit that helps employees meet their housing needs; and the Initiative to Reduce Barriers to Affordable Housing, which has established local partnerships in seven new states and localities in 2003. Additionally, Fannie Mae conducts various underwriting experiments aimed at eliminating obstacles faced by prospective homebuyers across the country. In 2003, Fannie Mae approved $222 million worth of Housing and Community Development place-based commitments for a total of 55 experiments.[117]

Fannie Mae's American Dream Commitment is part of its National Minority Homeownership Initiative which has pledged to contribute at least $700 billion in private capital to serve 4.6 million families towards President George W. Bush's goal of expanding homeownership to 5.5 million new minority Americans by the end of the decade. Towards this goal, in 2003, Fannie Mae executed 17 new Housing and Community Development lender partnerships which seek to provide $394 billion in affordable housing lending to minority families.[118]

Under the American Dream Commitment, Fannie Mae has committed to establishing 250 faith-based homeownership partnerships in communities across the country by the end of the current decade. The objective of this initiative is to build strong partnerships with national faith-based organizations in order to reach potential new homeowners, work with faith-based and nonprofit partners to help increase access to homeownership information and education, partner with lenders to increase access to mortgage financing, and provide faith-based organizations with the tools, training, and resources needed to advance their community development efforts. Fannie Mae's work under the Faith-Based Initiative in 2003 resulted in $125 million in mortgage financing to underserved families across the country.[119] Additionally, Fannie Mae attended more than 12 faith-based symposiums providing training and technical assistance to over 2,000 symposium attendees.[120]

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[109] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, pp. 9–10.

[110] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 62.

[111] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 62.

[112] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 62–64.

[113] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 2.

[114] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003, March 15*, 2004, pp. 62–64.

[115] Fannie Mae, *2003 Annual Housing Activities Report, 2004*, pp. 22–24.

[116] Fannie Mae, *2003 Annual Housing Activities Report, 2004*, pp. 13–16.

[117] Fannie Mae, *2003 Annual Housing Activities Report, 2004*, pp. 17–22.

[118] Fannie Mae, *2003 Annual Housing Activities Report, 2004*, pp. 16.

[119] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 17–18.

[120] Fannie Mae, ''Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac,'' July 16, 2004, p. I–60.

c. Partnerships—Freddie Mac

Freddie Mac does not have a partnership office structure similar to Fannie Mae's, but it has undertaken a number of initiatives in specific metropolitan areas.[121] Freddie Mac works with affordable housing lenders to design creative solutions to meet homeownership needs of specific populations in targeted areas; explore efficient use of public subsidies to make homeownership more affordable and develop homebuyer education/counseling and debt management assistance programs.[122] In 2001, Freddie Mac joined the Congressional Black Caucus to launch a new initiative, ''With Ownership Wealth,'' designed to increase African-American homeownership with one million new families by 2005.[123] Freddie Mac has partnered with the National Council of La Raza (NCLR), 20 community based NCLR affiliated housing counseling organizations, the National Association of Hispanic Real Estate Professionals (NAHREP), EMT Applications and participating Freddie Mac Seller/Servicers including Bank of America, U.S. Bank and Wells Fargo Home Mortgage on the ''En Su Casa'' initiative. This $200 million homeownership initiative combines technology tools with flexible mortgage products to meet the needs of Hispanic borrowers. Mortgage products include low down payments, flexible credit underwriting and debt-to-income ratios, and streamlined processing for resident alien borrowers.[124]

In 2002, Freddie Mac joined with the City of Boston and the U.S. Conference of Mayors to make available the ''Don't Borrow Trouble'' predatory lending educational campaign to approximately 1,100 cities. As of the end of 2003, the campaign has been launched in more than 30 localities. Additionally, in late 2003, Freddie Mac sponsored a national Don't Borrow Trouble summit. Attorneys, community activists and local leaders from 23 cities convened to share campaign experiences and to learn about emerging predatory lending trends from some of the nation's leading community lending experts.[125]

In addition, Freddie Mac joined with Rainbow/PUSH and the National Urban League to promote the CreditSmart® financial educational curriculum that helps consumers understand, obtain and maintain good credit, thereby preparing them for homeownership and other personal financial goals. Rainbow/PUSH has organized CreditSmart® classes with more than 80 churches across the nation, reaching more than 2,500 congregants. Bilingual curriculum was launched for this program in December 2002, and during 2003 CreditSmart® Español conducted a total of 23 Train-the-Trainer workshops for their partners and their local partners resulting in 326 trainers who are authorized to teach the CreditSmart® Español curriculum. Thus far 503 adults have been trained in the CreditSmart® Español financial literacy program.[126] The CreditSmart®/Homeownership Development Initiative with the National Urban League has nine affiliates located in Birmingham, AL; Charlotte, NC; Louisville, KY; Greenville, SC; Oklahoma City, OK; Springfield, IL; and Washington, DC; with Orlando, FL and Knoxville, TN added in 2003. Since the initiative's launch in early 2002, 41 CreditSmart® financial literacy workshops have been presented to more than 600 minority participants. Those participants are proceeding to the next steps to achieving homeownership, and in 2003 313 loans have closed as a direct result.[127]

In 2002 and 2003, Freddie Mac joined with the American Community Bankers, the Credit Union National Association, and the Independent Community Bankers of America in strategic alliances to better enable member banks and credit unions access to the secondary market.[128]

In June 2002, President George W. Bush challenged the nation's housing industry to invest more than $1 trillion to make homeownership a reality for 5.5 million more minority households for the decade. Freddie Mac responded to the challenge with Catch the Dream which is a comprehensive set of 25 high impact initiatives aimed at accelerating the growth in minority homeownership. The initiatives range from homebuyer education and outreach, to new technologies with innovative mortgage products. Freddie Mac has committed to purchase $400 billion in mortgages made to minority families by the end of the decade.[129] Catch the Dream represents a collaborative effort with lenders, nonprofit housing and community-based organizations, and other industry participants to expand homeownership opportunities for America's minorities.[130] In 2003 initiatives were implemented in Birmingham, Charlotte, Atlanta, DeKalb County (GA), Lansing, and San Antonio. In 2003, single-family owner occupied mortgage purchases financed homes for almost 700,000 minority families, including mortgages for 133,000 African-American and 250,000 Hispanic families (this comprised 16% of Freddie Mac's single-family, owner-occupied mortgage purchases and 22.6% of their first-time homebuyer mortgage purchases).[131]

The programs mentioned above are examples of the partnership efforts undertaken by the GSEs. There are more partnership programs than can be adequately described here. Fuller descriptions of these programs are provided in their Annual Housing Activity Reports.

d. Underwriting and GSE Purchase Guidelines

Lenders, mortgage insurers, and the GSEs have also been modifying their mortgage underwriting standards to address the needs of families who have historically found it difficult to qualify under traditional guidelines. In addition to the changes in underwriting standards, the use of automated underwriting has dramatically transformed the mortgage application process. This section focuses on changes to traditional underwriting standards and recent GSE initiatives for credit-impaired borrowers. Subsequent sections will provide more details on the impact of automated underwriting.

The GSEs modified their underwriting standards to address the needs of families who find qualifying under traditional guidelines difficult. The goal of these underwriting changes is not to loosen underwriting standards, but rather to identify creditworthiness by alternative means that more appropriately measures the unique circumstances of low-income, immigrant, and minority households. Examples of changes that the GSEs and others in the industry have made to their underwriting standards include the following:

- Using a stable income standard rather than a stable job standard (or a minimum period of employment). This particularly benefits low-skilled applicants who have successfully remained employed, even with frequent job changes.
- Using an applicant's history of rent and utility payments as a measure of creditworthiness. This measure benefits lower-income applicants who have not established a credit history.
- Allowing pooling of funds for qualification purposes. This change benefits applicants with extended family members. Freddie Mac, for example, allows income from relatives who live together to pool their funds to cover downpayment and closing costs and to combine their incomes for use in calculating the borrower's stable monthly income.

These underwriting changes have been accompanied by homeownership counseling to ensure homeowners are ready for the responsibilities of homeownership. In addition, the industry has engaged in intensive loss mitigation to control risks.

In 1999, HUD commissioned a study by the Urban Institute to examine the underwriting criteria that the GSEs use when purchasing mortgages from primary lenders.[132] According to the study, while the GSEs had improved their ability to serve low- and moderate-income borrowers, it did not

[121] Freddie Mac, *News Release*, January 15, 1999.

[122] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 3.

[123] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 67.

[124] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 66–67.

[125] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 37–38.

[126] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003, March 15, 2004*, pp. 38–39.

[127] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 39–40.

[128] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 42–43.

[129] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 4.

[130] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, pp. 29–30.

[131] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 30–34.

[132] Kenneth Temkin, Roberto Quercia, George Galster, and Sheila O'Leary, *A Study of the GSEs' Single Family Underwriting Guidelines: Final Report.* Washington DC: U.S. Department of Housing and Urban Development, April 1999.

appear at that time that they had gone as far as some primary lenders to serve these borrowers. From the Urban Institute's discussion with lenders, it was found that primary lenders were originating mortgages to lower-income borrowers using underwriting guidelines that allow lower down payments, higher debt-to-income ratios and poorer credit histories than allowed by the GSEs' guidelines.

From this and other evidence, the Urban Institute concluded that the GSEs were lagging the market in servicing low- and moderate-income and minority borrowers. Furthermore, the Urban Institute found ''that the GSEs' efforts to increase underwriting flexibility and outreach has been noticed and is applauded by lenders and community advocates. Despite the GSEs' efforts in recent years to review and revise their underwriting criteria, however, they could do more to serve low- and moderate-income borrowers and to minimize disproportionate effects on minorities.'' [133] Since the Urban Institute study, Freddie Mac and Fannie Mae have been playing a larger role in financing low-income and minority borrowers. (See Section E.2.)

In addition to offering low-down-payment programs, the GSEs' recent efforts have also centered around their automated underwriting systems and their treatment of borrowers with blemished credit, the latter being perhaps the most controversial underwriting issue over the past few years. Freddie Mac has a variety of products and initiatives aimed at providing borrowers with impaired credit more mortgage choices. These products include: CreditWorks℠ which helps borrowers with excessive debt and impaired credit to become eligible for a prime market rate mortgage faster than would otherwise be possible, Affordable Merit Rate℠ Mortgage which permits borrowers to qualify at an initial interest rate that in many cases is lower than the usual subprime rate, and LeasePurchase Plus Initiative, which provides closing cost and down payment assistance in addition to extensive counseling for borrowers who have had credit issues in the past or who have never established a credit history. During 2003, Freddie Mac entered into several new markets under the LeasePurchase Plus Initiative and purchased more than $16 million in loans.[134]

According to Freddie Mac, its automated underwriting system, ''Loan Prospector'' has reduced costs, made approving mortgages easier and faster, and increased the consistency of the application of objective underwriting criteria. In addition, Freddie Mac states that ''Loan Prospector'' extends the benefits of the mortgage finance system to borrowers with less traditional credit profiles and limited savings by more accurately measuring risk. Since its introduction in 1995, Freddie Mac reports that they have doubled their share of mortgage purchases with loan-to-value rations of 95 percent or above.[135] In 2003, lenders and brokers used Loan Prospector to evaluate 9.5 million loan applications and Loan Prospector has evaluated more than 35 million mortgage applications since its introduction in 1995.[136] Freddie Mac reports that its automated underwriting system, Loan Prospector, has resulted in higher approval rates for minority borrowers than under traditional manual underwriting because of improved predictive powers. As mentioned in Section C.7, the 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to 51.6 percent approved by manual underwriting. The Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk. However, as noted below in the automated mortgage scoring section, there are concerns that the codification of certain underwriting guidelines could result in unintentional discrimination or disparate treatment across groups. In response to the potential disparate impact of automated underwriting, Freddie Mac have launched initiatives to make the mortgage process more transparent by disclosing both credit and non-credit factors that Loan Prospector consider when evaluating a loan application. In 2000, Freddie Mac has launched an initiative that published a list of all of the factors that Loan Prospector uses to analyze loans, and put the list on the Freddie Mac website.[137]

In 2003, Fannie Mae released two versions of its automated underwriting service, ''Desktop Underwriter'' (DU), to expand its mortgage product offerings and to update underwriting guidelines. Desktop Underwriter® 5.3 outlined new eligibility requirements for mortgages secured by manufactured homes. It also expanded the InterestFirst™ mortgage product line to offer borrowers greater purchasing power by allowing lower initial monthly payments than those available with traditional loan products. Desktop Underwriter® 5.3.1 enhanced the Flexible 100 mortgage to allow borrowers to contribute as little as $500 of their own funds to the transaction. The remainder of the funds can come from flexible sources of funds and interested party contributions subject to Fannie Mae's standard contribution limit.[138] In addition, Fannie Mae added MyCommunityMortgage to Desktop Underwriter® in 2003, providing lenders easier access to customized CRA-targeted loan products.[139] Automated mortgage scoring and the potential for disparate impacts on borrowers will be further discussed in a later section.

5. Affordable Single-family Lending: Data Trends

a. 1993–2003 Lending Trends

HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low-income and minority families increased at much faster rates than loans to higher income and non-minority families. As shown below, conventional home purchase originations to African Americans more than doubled between 1993 and 2003 and those to Hispanic borrowers more than tripled. Home loans to low-income borrowers and to low-income and high-minority census tracts also more than doubled during this period.

	1993–2003 Growth rate: all home loans (percent)	1993–2003 Growth rate: conventional home loans (percent)
African-American Borrowers	106	206
Hispanic Borrowers	235	357
White Borrowers	44	64
Low-Income Borrower (Less than 80% of AMI)	101	150
Upper-Income Borrower (More than 120% of AMI)	88	108
Low-Income Census Tract (only 1993–2002)	99	143
Upper-Income Census Tract (only 1993–2002)	64	78
High-Minority Tract (only 1993–2002) (50% or more minority)	113	167
Predominantly-White Tract (only 1993–2002) (Less than 10% minority)	53	64

[133] Temkin, *et al.* 1999, p. 28.

[134] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, pp. 36–37.

[135] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 5.

[136] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 19.

[137] Freddie Mac, *2002 Annual Housing Activities Report, 2003,* p. 57.

[138] Fannie Mae, *2003 Annual Housing Activities Report, 2004,* pp. 11–12.

[139] Fannie Mae, ''Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac,'' July 16, 2004, p. I–57.

GSE purchases showed similar trends, as indicated by the following 1993-to-2003 percentage point increases for metropolitan areas: African-American borrowers (199 percent), Hispanic borrowers (259 percent), and low-income borrowers (212 percent). While their annual purchases of all home loans increased by 60 percent between 1993 and 2003, their purchases of mortgages that qualify for the three housing goals increased as follows: special affordable by 287 percent; low- and moderate-income by 156 percent; and underserved areas by 121 percent.

While low interest rates and economic expansion certainly played an important role in the substantial increase in conventional affordable lending in recent years, most observers believe that the efforts of lenders, private mortgage insurers, and the GSEs were also important contributors. In addition, many observers believe that government initiatives such as the GSE housing goals and the Community Reinvestment Act have also played a role in the growth of affordable lending over the past 10 years.

b. Affordable Lending Shares by Major Market Sector

Section E below compares the GSEs' performance with the performance of primary lenders in the conventional conforming market. To provide a useful context for that analysis, this section examines the role of the conventional conforming market in funding low-income and minority families and their neighborhoods. Information on the mortgage market's funding of homes purchased by first-time homebuyers is also provided. In addition, this section compares the GSEs with other sectors of the mortgage market. The important role of FHA in the affordable lending market is highlighted and questions are raised about whether the conventional conforming market could be doing a better job helping low-income and minority borrowers obtain access to mortgage credit.

Table A.1 reports borrower characteristics and Table A.2 reports neighborhood characteristics for home purchase mortgages insured by FHA, purchased by the GSEs, originated by depository institutions (mainly banks and thrift), and originated in the conventional conforming market and in the total market for owner-occupied properties in metropolitan areas.[140] In this case, the ''total'' market consists of both the conventional conforming market and the government (mainly FHA and VA loans) market; ''jumbo'' loans above the conventional conforming loan limit are excluded from this analysis.[141]

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[140] Table A.3 also provides the same average (1999 to 2003) information as Tables A.1 and A.2 but for total (both home purchase and refinance) loans. Thus, it provides a complete picture of overall mortgage activity.

[141] The ''Total Market'' is defined as all loans (including both government and conventional) below the conforming loan limit of $240,000 in 1999, $252,700 in 2000, $275,000 in 2001, $300,700 in 2002 and $322,700 in 2003.

Table A.1

Borrower Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas Home Purchase Mortgages, 1996-2003

			Conventional Conforming Market						
						Depositories		Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C [2]
Low-Income:									
1999	34.4 %	49.5 % [1]	25.1 %	24.7 %	24.8 %	29.1 %	28.5 %	30.1 %	29.8 %
2000	33.5	48.7	27.8	25.4	26.4	29.4	28.6	29.5	29.1
2001	33.0	50.7	26.8	27.9	27.4	28.2	29.2	28.3	28.1
2002	33.7	54.2	28.6	29.7	29.2	29.4	30.3	29.3	29.2
2003	34.4	54.1	28.6	31.0	30.2	29.5	29.5	29.1	29.1
1996-2003 Average	32.8	49.8	25.3	26.7	26.1	28.2	28.9	28.6	28.5
1999-2003 Average	33.4	51.2	27.4	28.1	27.8	29.1	29.2	29.2	29.1
2001-2003 Average	33.1	52.8	28.0	29.6	29.0	29.1	29.7	28.9	28.8
African American:									
1999	7.9	14.6	3.5	3.4	3.5	4.7	4.7	5.4	5.0
2000	8.3	15.5	4.3	4.2	4.3	5.4	5.0	5.9	5.4
2001	7.6	14.0	3.9	5.2	4.6	4.8	4.9	5.4	5.0
2002	7.5	13.9	3.5	5.4	4.7	4.9	4.8	5.7	5.2
2003	7.6	13.2	3.8	5.8	5.2	5.5	5.2	6.5	6.0
1996-2003 Average	7.7	14.3	3.7	4.7	4.3	4.9	4.8	5.5	5.2
1999-2003 Average	7.8	14.3	3.8	5.0	4.5	5.1	4.9	5.8	5.3
2001-2003 Average	7.6	13.8	3.7	5.5	4.8	5.1	5.0	5.9	5.4
Hispanic:									
1999	9.7	19.3	5.5	6.0	5.8	6.5	6.6	7.1	6.9
2000	10.9	20.7	6.6	8.0	7.4	7.9	7.8	8.3	8.1
2001	11.3	20.3	7.0	8.5	7.9	8.5	9.4	9.0	8.7
2002	12.1	20.6	6.6	10.4	9.0	9.3	9.2	10.3	9.8
2003	12.6	19.4	6.9	10.8	9.6	10.0	9.8	11.7	10.9
1996-2003 Average	10.4	19.2	6.0	8.2	7.3	7.5	7.3	8.3	8.0
1999-2003 Average	11.4	20.1	6.6	9.0	8.1	8.5	8.5	9.4	9.0
2001-2003 Average	12.0	20.1	6.8	10.0	8.8	9.3	9.5	10.4	9.9
Minority:									
1999	23.4	37.7	15.0	17.4	16.4	17.7	17.3	19.0	18.4
2000	25.3	40.2	17.6	20.2	19.0	20.3	19.7	21.1	20.4
2001	25.1	38.0	18.3	21.9	20.3	20.3	21.4	21.5	20.8
2002	26.7	38.5	18.9	24.9	22.7	22.1	21.4	24.1	23.1
2003	27.2	36.0	18.3	25.3	23.1	22.9	21.9	25.8	24.5
1996-2003 Average	24.0	37.2	16.3	20.8	19.0	19.0	18.2	20.6	19.8
1999-2003 Average	25.6	38.2	17.7	22.5	20.6	20.8	20.3	22.5	21.6
2001-2003 Average	26.4	37.6	18.5	24.2	22.1	21.8	21.6	24.0	22.9

Notes: The "1999-2003 Average" is a loan-based weighted average. All the data are for home purchase mortgages. The FHA, depositories, and market percentages are derived from HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001, 2002 and 2003; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001or 2002 or 2003) as well as their purchases of mortgages originated during 1999, 2000, 2001, 2002 and 2003. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $322,700 in 2003. "Total Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The "Portfolio Depositories" data refer to new originations that are not sold by banks and thrift institutions during 1999-2003 and thus are retained in depository portfolios. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on a "distribution of business" approach or explained in the text. For example, in 1999, 49.5 percent of FHA-insured home loans were loans for low-income borrowers.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market.

Table A.2

Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas Home Purchase Mortgages, 1996-2003

			Conventional Conforming Market						
						Depositories		Conforming Market	
Neighborhood Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Total	Portfolio	Total	W/O B&C
Low-Income Tract:									
1999	12.7	18.2	8.3	7.9	8.1	10.8	11.6	11.3	10.9
2000	13.3	19.2	9.0	9.5	9.3	11.9	12.4	11.9	11.4
2001	12.5	18.2	9.4	10.1	9.8	11.0	12.3	11.0	10.7
2002	12.6	18.8	11.3	11.0	11.1	11.0	12.1	11.4	11.1
2003	12.7	18.0	10.3	11.0	10.8	11.3	12.1	12.0	11.5
1996-2003 Average	12.7	18.6	9.1	9.8	9.5	10.8	12.0	11.3	11.0
1999-2003 Average	12.8	18.5	9.7	10.1	9.9	11.2	12.1	11.5	11.1
2001-2003 Average	12.6	18.3	10.3	10.7	10.6	11.1	12.2	11.5	11.1
High-Minority Tract:									
1999	17.5	26.0	12.3	12.8	12.6	13.9	13.5	15.1	14.6
2000	18.4	26.5	12.8	15.3	14.2	15.6	14.8	16.3	15.7
2001	17.7	24.3	13.2	15.6	14.6	15.2	16.0	16.0	15.4
2002	18.6	24.0	16.2	17.3	16.9	16.1	15.4	17.5	16.7
2003 (2000Census)	32.1	39.1	24.8	30.0	28.3	28.1	26.8	31.1	29.7
1996-2002 Average	17.7	25.9	12.8	15.1	14.2	14.2	13.9	15.4	14.9
1999-2002 Average	18.1	25.2	13.7	15.4	14.7	15.3	15.0	16.3	15.7
High African-American Tract:									
1999	5.7	8.9	3.4	3.0	3.2	4.3	4.4	4.8	4.4
2000	6.0	9.4	3.9	3.7	3.8	4.9	4.8	5.1	4.7
2001	5.4	8.5	3.9	4.4	4.2	4.4	4.7	4.6	4.3
2002	5.5	8.4	5.3	4.7	4.9	4.5	4.8	4.8	4.6
2003 (2000Census)	7.4	11.5	5.9	6.3	6.1	6.2	6.2	6.7	6.4
1996-2002 Average	5.7	9.1	3.8	4.0	3.9	4.4	4.6	4.7	4.5
1999-2002 Average	5.7	8.8	4.2	4.0	4.1	4.6	4.7	4.8	4.5
Underserved Areas:									
1999	29.1	40.5	20.9	20.4	20.6	24.6	25.6	25.8	25.2
2000	30.2	42.1	22.0	23.4	22.8	26.6	27.0	27.0	26.2
2001	28.9	40.3	22.3	24.4	23.5	25.4	27.2	25.8	25.2
2002	29.5	40.9	25.8	26.7	26.3	26.0	27.1	27.1	26.3
2003	30.0	39.4	24.0	26.8	25.9	26.8	27.8	28.5	27.6
1996-2003 Average	29.3	40.8	22.0	24.0	23.2	25.1	26.5	26.3	25.7
1999-2003 Average	29.6	40.7	23.1	24.7	24.1	25.9	26.9	26.9	26.2
2001-2003 Average	29.5	40.2	24.1	26.0	25.3	26.1	27.4	27.2	26.4

See notes to Table A.1.

Additional Note: In 2003, High-Minority tracts and High African-American tracts are defined in terms of 2000 census, which explains their higher percentages. Only the averages through year 2002 are represented here.

Table A.3

Borrower and Neighborhood Characteristics for Major Sectors of the Mortgage Market in Metropolitan Areas Home Purchase and Refinance Mortgages, 1999-2003

			Conventional Conforming Market					
							Conforming Market	
Borrower Characteristics	Total Market	FHA	Freddie Mac	Fannie Mae	Both GSEs	Depositories	Total	W/O B&C [2]
Low-Income:	29.9 %	50.2 % [1]	25.0 %	26.5 %	25.9 %	27.3 %	28.0 %	27.3 %
African American:	6.7	14.8	3.3	4.1	3.8	4.8	5.5	4.9
Hispanic:	9.1	19.0	5.6	7.6	6.8	7.2	8.0	7.7
Minority:	22.1	37.5	16.4	19.3	18.1	18.5	20.2	19.3
Neighborhood Characteristics								
Low-Income Tract:	11.7	17.6	8.9	9.3	9.1	10.4	11.1	10.5
Underserved Areas:	27.7	39.9	22.1	23.8	23.1	24.8	26.2	25.2

Notes: The "1999-2003 Average" is a loan-based weighted average. All the data are for home purchase and refinance mortgages. The FHA, depositories, and market percentages are derived from 1999, 2000, 2001, 2002 and 2003 HMDA data (various years). The GSE percentages are derived from the loan-level data that Fannie Mae and Freddie Mac provide to HUD. The GSE data include conventional home loans purchased during 1999, 2000, 2001, 2002 and 2003; thus, these data include their purchases of seasoned loans (i.e., mortgages originated prior to 1999 or 2000 or 2001 or 2002 or 2003) as well as their purchases of mortgages originated during 1999, 2000, 2001, 2002 and 2003. The "Total Market" combines the government sector (FHA and VA loans) and the conventional conforming market. Thus, it includes all loans except "jumbo" loans above the conforming loan limit which was $322,700 in 2003. "Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and The National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidiaries. The HMDA data for low-income borrowers exclude mortgages with a loan-to-borrower-income ratio greater than six.

[1] Each percentage represents the share of a sector's portfolio accounted for by the borrower or neighborhood characteristic based on "distribution of business" approach or explained in the text. For example, 50.2 percent of FHA-insured home loans between 1999 and 2003 were loans for low-income borrowers. It should be noted that due to FHA's streamline refinance program, borrower income data were not available for almost 70 percent of FHA's refinance loans.

[2] HMDA-based market shares that have been adjusted to exclude the B&C portion of the subprime market.

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HMDA is the source of the FHA, depository, and market data, while the GSEs provide their own data. Low-income, African-American, Hispanic, and minority borrowers are covered in Table A.1. Table A.2 provides information on four types of neighborhoods—low-income census tracts, tracts where minorities (or African Americans) account for more than 30 percent of the census tract population, and underserved areas as defined by HUD. The average data reported in Tables A.1 and A.2 for the years 1999 to 2003 offer a good summary of recent lending to low-income and minority borrowers and their communities.[142] Individual year data are also provided.

The focus of different market sectors on affordable lending is summarized by the percentages reported in Tables A.1 and A.2. These percentages show each sector's ''distribution of business,'' defined as the share of loans originated (or, for the GSEs, purchased) that had a particular borrower or neighborhood characteristic. The interpretation of the ''distribution of business'' percentages can be illustrated using the FHA percentage for low-income borrowers: Between 1999 and 2003, 51.2 percent of all FHA-insured home purchase loans in metropolitan areas were originated for borrowers with an income less than 80 percent of the local area median income. These percentages are to be contrasted with ''market share'' percentages, which are presented below in Section E. A ''market share'' percentage is the share of loans with a particular borrower or neighborhood characteristic that was funded by a particular market sector (*e.g.*, FHA-insured, GSEs, depositories). As will discussed below, FHA's ''market share'' for low-income borrowers during the 1999-to-2003 period was estimated to be 24 percent which is interpreted as follows: Of all home purchase loans originated for low-income borrowers in metropolitan areas between 1999 and 2003, 24 percent were FHA-insured loans. Thus, in this example, the ''distribution of business'' percentage measures the importance (or concentration) of low-income borrowers in FHA's overall business while the ''market share'' percentage measures the importance of FHA to the market's overall funding of loans for low-income borrowers. Both concepts are important for evaluating performance—for an industry sector such as FHA or the GSEs to have a significant impact on lending to a targeted group, that sector's business must be concentrated on the targeted group and that sector must be of some size. The discussion below will focus on the degree to which different mortgage sectors concentrate on targeted groups, while Section E will also provide estimates of market shares.

The main insights from the ''distribution of business'' percentages in Tables A.1 and A.2 pertain to four topics.

(i) *FHA-Insured Loans.* FHA has traditionally been the mechanism used by borrowers who face difficulty obtaining mortgage financing in the private conventional market. FHA has long been recognized as the major source of funding for first-time, low-income and minority homebuyers who are not often able to raise cash for large downpayments.[143] Tables A.1 and A.2 show that FHA places much more emphasis on affordable lending than the other market sectors. Between 1999 and 2003, low-income borrowers accounted for 51.2 percent of FHA-insured loans, compared with 27.8 percent of the home loans purchased by the GSEs, 29.1 percent of home loans originated by depositories, and 29.2 percent of all originations in the conventional conforming market (see Table A.1). Likewise, 40.7 percent of FHA-insured loans were originated in underserved census tracts, while only 24.1 percent of the GSE-purchased loans, 25.9 percent of home loans originated by depositories, and 26.9 percent of conventional conforming loans were originated in these tracts (see Table A.2).[144] As discussed in Section E, FHA's share of the minority lending market is particularly high. While FHA insured only 16 percent of all home purchase mortgages originated below the conforming loan limit in metropolitan areas between 1999 and 2003, it is estimated that FHA insured 29 percent of all home loans originated for African-American and Hispanic borrowers.

(ii) *Conventional and GSE Minority Lending.* The affordable lending shares for the conventional conforming sector are low for minority borrowers, particularly African-American and Hispanic borrowers. These borrowers accounted for only 15.2 percent of all conventional conforming loans originated between 1999 and 2003, compared with 34.4 percent of FHA-insured loans and 19.2 percent of all loans originated in the total (government and conventional conforming) market. Not surprisingly, the minority lending performance of conventional lenders has been subject to much criticism. Recent studies contend that primary lenders in the conventional market are not doing their fair share of minority lending which forces minorities, particularly African-American and Hispanic borrowers, to rely on more costly FHA and subprime loans.[145] Thus, it appears that conventional lenders could be doing a better job helping minority borrowers obtain access to mortgage credit.

- The GSEs' funding of minority loans can be compared with mortgages originated for minority borrowers in the conventional conforming market, although the latter may be a poor benchmark, as discussed above. Between 1999 and 2003, home purchase loans to African-American and Hispanic borrowers accounted for 10.4 percent of Freddie Mac's purchases, 14.0 percent of Fannie Mae's purchases, and 15.2 percent of loans originated in the conventional conforming market (or 14.3 percent if B&C loans are excluded from the market definition). Thus, since 1999, the African-American and Hispanic share of the GSEs' purchases has been lower than the corresponding share for the conventional conforming market.[146]
- As the above comparisons show, Fannie Mae has had a much better record than Freddie Mac in funding loans for minority families. And Fannie Mae significantly increased its purchases of loans for African-American and Hispanic borrowers during 2001, raising the share of its purchases to market levels—13.7 percent for both Fannie Mae and the conforming market (without B&C loans). In 2002, Fannie Mae surpassed

[142] The affordable market shares reported in Table A.1 for the ''Conventional Conforming Market W/O B&C'' were derived by excluding the estimated number of B&C loans from the market data reported by HMDA. Because B&C lenders operate mainly in the refinance sector, excluding these loans from the conforming market has little impact on the home purchase percentages reported in Table A.1. It should be recognized that there exists some uncertainty regarding the number of B&C loans in the HMDA data. The adjustment assumes that the B&C loans represent one-half of the subprime market. The adjustment for home purchase loans is small because supbrime (B&C) loans are mainly refinance loans. The method for excluding B&C loans is explained in Section E below and Appendix D.

[143] Almost two-thirds of the borrowers with an FHA-insured home purchase loan make a downpayment less than five percent, and over 80 percent are first-time home buyers. For discussions of the role of FHA in the mortgage market, see (a) Harold L. Bunce, Charles A. Capone, Sue G. Neal, William J. Reeder, Randall M. Scheessele, and Edward J. Szymanoski, *An Analysis of FHA's Single-Family Insurance Program,* Office of Policy Development and Research, U.S. Department of Housing and Urban Development, 1995; and (b) Office of Policy Development and Research, ''FHA's Impact on Homeownership Opportunities for Low-Income and Minority Families During the 1990s'' *Issue Brief IV,* U.S. Department of Housing and Urban Development, December 2000. For data on the credit characteristics of FHA borrowers, see Harold L. Bunce, William J. Reeder and Randall Scheessele, ''Understanding Consumer Credit and Mortgage Scoring: A Work in Progress at HUD'', U.S. Department of Housing and Urban Development, Unpublished Paper, 1999.

[144] FHA, which focuses on low downpayment loans and also accepts borrowers with credit blemishes, experiences higher mortgage defaults than conventional lenders and the GSEs. Still, the FHA system is actuarially sound because it charges an insurance premium that covers the higher default costs. For the results of FHA's actuarial analysis, see Deloitte & Touche, *Actuarial Review of MMI Fund as of FY 2000,* report for the U.S. Department of Housing and Urban Development, January 2001.

[145] See Green and Associates, *Fair Lending in Montgomery County: A Home Mortgage Lending Study,* a report prepared for the Montgomery County Human Relations Commission, March 1998; and Calvin Bradford, *Crisis in Déjà vu: A Profile of the Racial Patterns in Home Purchase Lending in the Baltimore Market.* Report for The Public Justice Center, May 2000; and *The Patterns of GSE Participation in Minority and Racially Changing Markets Reviewed from the Context of Levels of Distress Associated with High Levels of FHA Lending,* GSE Study No. 11, U.S. Department of Housing and Urban Development, September 2000. For analysis suggesting some minorities receiving FHA loans could qualify for conventional loans, see Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Working Paper No. 00–03. Research Institute for Housing America, 2000. Also see the series of recent studies concerning the lack of mainstream lenders in minority neighborhoods.

[146] For a comprehensive analysis of the GSEs' purchases of minority loans through 1999, see Harold L. Bunce, *An Analysis of GSE Purchases of Mortgages for African-American Borrowers and their Neighborhoods,* Housing Finance Working Paper No. 11, Office of Policy Development and Research, HUD, December 2000.

the conventional conforming market in funding African-American and Hispanic borrowers (a 15.8 percent share for Fannie Mae and a 15.0 share for the market), but in 2003 fell slightly behind the market (a 16.6 percent share for Fannie Mae and a 16.9 percent share for the market). When all minority borrowers are considered, Fannie Mae has purchased mortgages for minority borrowers at a higher rate (years 2001, 2002 and 2003) than these loans were originated by primary lenders in the conventional conforming market (without B&C loans). Freddie Mac, on the other hand, lagged behind both the market and Fannie Mae in funding loans for minority borrowers during 2001–2003, as well as during the entire 1999-to-2003 period. The share of Freddie Mac's purchases for African-American and Hispanic borrowers declined from 10.9 percent in both 2000 and 2001 to 10.1 percent in 2002 before rising slightly to 10.7 percent in 2003.

- Considering the minority census tract data reported in Table A.2, Fannie Mae lagged behind the conforming market (without B&C loans) in high-minority neighborhoods and in high-African-American neighborhoods during the 1999-to-2003 period. However, Fannie Mae improved its mortgage purchases in African-American neighborhoods after 2001 and essentially matched the market in 2001–2003. And during 2001, 2002 and 2003, Fannie Mae also purchased loans in high-minority census tracts at a higher rate than loans were originated by conventional lenders in these tracts. While Freddie Mac has generally lagged the primary market in funding minority neighborhoods, note in Table A.2 that high African-American tracts increased from 3.9 percent of Freddie Mac's purchases in 2001 to 5.3 percent in 2002, placing Freddie Mac above the conventional conforming market level (4.6 percent) in 2002. However, in 2003, Freddie Mac fell behind the market.

(iii) *Low-Income Lending by the GSEs.* Information is also provided on the GSEs' purchases of home loans for low-income borrowers (A.1) and for families living in low-income neighborhoods (A.2). Historically, the GSEs have lagged behind the conventional conforming market in funding affordable loans for these groups. During the 1999-to-2003 period, low-income borrowers (census tracts) accounted for 27.4 (9.7) percent of Freddie Mac's purchases, 28.1 (10.1) percent of Fannie Mae's purchases, 29.1 (11.2) percent of loans originated by depositories, and 29.1 (11.1) percent of home loans originated by conventional conforming lenders (without B&C loans). By the end of this period, Fannie Mae had significantly improved its performance relative to the market. In 2003, low-income borrowers accounted for 31.0 percent of Fannie Mae's purchases, compared with 29.2 percent for the conforming market. It is also interesting that even though Freddie Mac lagged the market in funding home loans for low-income borrowers during 2002 (28.6 percent versus 29.1 percent), it surpassed the market in financing properties in low-income census tracts (11.3 percent versus 11.1 percent). During 2003, Freddie Mac's performance was again below the market in low-income census tracts (a 10.3 share for Freddie Mac and a 11.5 percent share for the market). A more complete analysis of the GSEs' recent improvements in purchasing home loans that qualify for the housing goals is provided below in Section E.

(iv) *Depositories.* Within the conventional conforming market, depository institutions (mainly banks and thrifts) are important providers of affordable lending for lower-income families and their neighborhoods.[147] Between 1999 and 2003, underserved areas accounted for 26.9 percent of loans held in depository portfolios, which compares favorably with the underserved areas percentage (26.2 percent) for the overall conventional conforming market.[148] Depository lenders have extensive knowledge of their communities and direct interactions with their borrowers, which may enable them to introduce flexibility into their underwriting standards without unduly increasing their credit risk. The Community Reinvestment Act provides an incentive for banks and thrifts to initiate affordable lending programs with underwriting flexibility and to reach out to lower income families and their communities.[149] Many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac.

(v) *First-time Homebuyers.* As explained in Section E, market information on first-time homebuyers is not as readily available as the HMDA data reported in Tables A.1 and A.2 on the income and racial characteristics of borrowers and census tracts served by the mortgage market. However, the limited market data that are available from the American Housing Survey, combined with the first-time homebuyer data reported by FHA and the GSEs, indicate a rather large variation in the funding of first-time homebuyers across the different sectors of the mortgage market. Based on the American Housing Survey (AHS), it is estimated that first-time homebuyers accounted for 42.3 percent of all home purchase loans originated throughout the market between 1999 and 2001,[150] and for 37.6 percent of home loans originated in the conventional conforming market. The AHS defines a first-time homebuyer as someone who has never owned a home. Using a more liberal definition of a first-time homebuyer (someone who has not owned a home in the past three years), FHA reports that first-time homebuyers accounted for 80.5 percent of all home loans that it insured between 1999 and 2001 and the GSEs report that first-time homebuyers accounted for 26.5 percent of the home loans purchased by each GSE during that same period. Given FHA's low downpayment requirements, it is not surprising that FHA focuses on first-time homebuyers. The GSEs, on the other hand, fall at the other end of the continuum, with their first-time homebuyer share (26.5 percent) falling far short of the first-time homebuyer share (37.6 percent) of the conventional conforming market. Section E will include a more detailed comparison of the GSEs and the conventional conforming market in serving first-time homebuyers. In addition, Section E will conduct a market share analysis that examines the funding of minority first-time homebuyers. Consistent with the earlier discussion, that analysis suggests that conventional lenders and the GSEs have played a relatively small role in the market for minority first-time homebuyers. One analysis reported in Section E estimates that mortgage purchases by the GSEs between 1999 and 2001 totaled 41.5 percent of all home loans originated, but they accounted for only 14.3 percent of home loans originated for first-time African-American and Hispanic homebuyers.

c. Community Reinvestment Act

The Community Reinvestment Act (CRA) requires depository institutions to help meet the credit needs of their communities.[151] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. CRA provides an incentive for lenders to initiate affordable lending programs with underwriting flexibility. CRA loans are usually smaller than typical conventional mortgages and also are more likely to have a higher LTV, higher debt-to-income ratios and no payment reserves, and may not be carrying private mortgage insurance (PMI). Generally, at the time CRA loans are originated, many do not meet the underwriting guidelines required in order for them to be purchased by one of the GSEs. Therefore, many of the CRA loans are held in portfolio by lenders, rather than sold to Fannie Mae or Freddie Mac. Evidence is growing that CRA-type lending to low-income families can be profitable, particularly when combined with intensive loss mitigation efforts to control credit risk. In a recent survey conducted by the Federal

[147] Tables A.1, A.2, and A.3 include data for all home loans originated by depositories as well as for the subset of loans originated but not sold, the latter being a proxy for loans held in depository portfolios. (See the notes to Table A.1 for definitions of the depository data.)

[148] However, as shown in Table A.1 , depository institutions resemble other conventional lenders in their relatively low level of originating loans for African-American, Hispanic and minority borrowers. Within the conventional conforming market, Fannie Mae has done a better job than depositories in funding minority borrowers, particularly Hispanic borrowers and minority borrowers as a group. During the last three years, Fannie Mae has also funded African-American borrowers at a higher rate than have depository institutions.

[149] CRA loans are typically made to low-income borrowers earning less than 80 percent of area median income, and in moderate-income neighborhoods. For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report,* U.S. Department of Treasury, 2000.

[150] In this case, the market includes all government and conventional loans, including jumbo loans.

[151] For a comprehensive analysis of CRA and its impact on affordable lending, see Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky and Susan White Haag, *The Community Reinvestment Act After Financial Modernization: A Baseline Report*, U.S. Department of Treasury, 2000.

Reserve, lenders reported that most CRA loans are profitable although not as profitable as the lenders' standard products.[152]

Some anticipate that the big growth market over the next decade for CRA-type lending will be urban areas. There has been some movement of population back to cities, consisting of aging Baby Boomers (so-called ''empty nesters''), the children of Baby Boomers (the Echo Boomers aged 18–25), and immigrants, particularly Hispanics but also Asians.[153] The current low homeownership in inner cities (compared with the suburbs) also suggests that urban areas may be a potential growth market for lenders. Lenders are beginning to recognize that urban borrowers are different from suburban borrowers. A new or recent immigrant may have no credit history or, more likely, a loan-worthy credit history that can't be substantiated by the usual methods.[154] Products for duplexes and four-plexes are not the same as a mortgage for a subdivision house in the suburbs. Programs are being implemented to meet the unique needs of urban borrowers. One program emphasizing urban areas was initiated by the American Community Bankers (ACB). Under the ACB program, which made $16.2 billion in loans in 2002, lenders originated a variety of affordable products for first-time homebuyers and non-traditional borrowers that are then sold to Fannie Mae, Freddie Mac, Countrywide, or other investors that are partnering with the ACB. It is reported that some lenders are making these non-traditional loans for the first time.

For banks and thrifts, selling their CRA loans will free up capital to make new CRA loans. As a result, the CRA market segment provides an opportunity for Fannie Mae and Freddie Mac to expand their affordable lending programs. Section E.3c below presents data showing that purchasing targeted seasoned loans has been one strategy that Fannie Mae has chosen to improve its goals performance. Fannie Mae has been offering CRA programs since mid-1997, when it launched a pilot program, ''Community Reinvestment Act Portfolio Initiative,'' for purchasing seasoned CRA loans in bulk transactions, taking into account track record as opposed to relying just on underwriting guidelines. Fannie Mae also started another pilot program in 1998, involving purchases of CRA loans on a flow basis, as they are originated. As part of the American Dream Commitment, Fannie Mae has committed to investing $20 billion in CRA-targeted business, and funding $530 billion in CRA-eligible investments. One CRA-eligible product in 2003 included the MyCommunityMortgage™ suite, which provides flexible product options for low- to moderate-income families, including minorities, immigrants, first-time homebuyers, and underserved borrowers living in rural areas. MyCommunityMortgage is offered by over 300 lender partners nationwide, and marries targeted pricing with affordability features, such as 100 percent loan-to-value ratios with only $500 from the borrower's own funds.[155] In 2003, Fannie Mae purchased or securitized more than $2.27 billion of MyCommunityMortgage products, which helped provide affordable housing solutions for 20,400 households.[156]

In addition, Freddie Mac is also purchasing seasoned affordable mortgage portfolios originated by depositories to help meet their CRA objectives. In 2003, Freddie Mac developed credit enhancements that enable depositories to profitably sell their loans to Freddie Mac—these transactions facilitate targeted affordable lending activity by providing immediate liquidity. Freddie Mac also increased its ability to purchase smaller portfolios opening this option to many community banks that otherwise would not have an outlet for their portfolios.[157] The billions of dollars worth of CRA loans that will be originated, as well as the CRA loans being held in bank and thrift portfolios, offer both GSEs an opportunity to improve their performance in the single-family area.

6. Potential Homebuyers

While the growth in affordable lending and homeownership has been strong in recent years, attaining this Nation's homeownership goals will not be possible without tapping into the vast pool of potential homebuyers. Due to record low interest rates, expanded homeownership outreach, and new flexible mortgage products, the homeownership rate reached an annual record of 67.9 percent in 2002, reaching 68.6 percent in the fourth quarter of 2003.[158] This section discusses the potential for further increases beyond those resulting from current demographic trends.

The potential homeowner population over the next decade will be highly diverse, as growing housing demand from immigrants (both those who are already here and those projected to come) and non-traditional homebuyers will help to offset declines in the demand for housing caused by the aging of the population. As noted in the above discussion of CRA, many of these potential homeowners will be located in urban areas. As noted in the above discussion of underlying demographic conditions (section C.2.), immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years. This trend does not depend on the future inflow of new immigrants, as immigrants don't enter the housing market until they have been in this country for eleven years. As noted by Fannie Mae staff, ''there are enough immigrants already in this country to keep housing strong for at least six and perhaps even 10 more years''.[159] As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new homeowners.

Surveys indicate that these demographic trends will be reinforced by the fact that most Americans desire, and plan, to become homeowners. According to the 2002 Fannie Mae Foundation annual National Housing Survey, Americans rate homeownership as the best investment they can make, far ahead of 401Ks, retirement accounts, and stocks. The percentage of Americans who said it was a good time to buy a home was at its highest level since 1994 at 75 percent, a jump of 21 percentage points since May 2001.[160] In addition, the survey found that 27 percent of Americans report they are likely to buy in the next three years, and 23 percent of those have started to save or have saved enough money for a down payment.[161]

Further increases in the homeownership rate depend on whether or not recent gains in the home owning share(s) of specific groups are maintained. Minorities accounted for 17 percent of owner households in 2001, but the Joint Center for Housing Studies reports that minorities were responsible for more than 40 percent (a total of 5.2 million) of the net growth in homeowners between 1993 and 2002.[162] As reported by the Fannie Mae survey, 42 percent of African-American families reported that they were ''very or fairly likely'' to buy a home in the next three years, up from 38 percent in 1998 and 25 percent in 1997. Among Hispanics and Hispanic immigrants, the numbers reached 37 percent and 34 percent respectively. The 2002 survey also reports that more than half of Hispanic renters cite homeownership as being ''one of their top priorities''. In addition, nearly a third (31 percent) of baby boomers said they are ''very or fairly likely'' to buy a home in the next three years.

In spite of these trends, potential minority and immigrant homebuyers see more obstacles to buying a home, compared with the general public. These barriers to homeownership are discussed in detail in section B.1.b above and include: lack of capital for down payment and closing costs; poor credit history; lack of access to mainstream lenders; complexity and fear of the homebuying process; and, continued discrimination in housing markets and mortgage lending. To address the needs of the new group of potential homeowners, the mortgage industry will have to address these needs on several fronts, such as expanding education and outreach efforts, introducing new products, and adjusting current underwriting standards to better reflect the

[152] Board of Governors of the Federal Reserve System. *The Performance and Profitability of CRA-Related Lending.* Washington, DC, 2000.

[153] This discussion of urban lending draws from Jeff Siegel, ''Urban Lending Helps Increase Volume and Meet CRA Requirements,'' *Secondary Marketing Executive,* February 2003, pp. 21–23.

[154] Ibid.

[155] Fannie Mae, ''Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac,'' July 16, 2004, p. I–59.

[156] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, pp. 8–9.

[157] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 64.

[158] U.S. Department of HUD, Office of Policy Development and Research, *U.S. Housing Market Conditions*, May 2004, p. 81.

[159] *Ibid.*

[160] Fannie Mae, *Fannie Mae National Housing Survey,* 2002, p. 6.

[161] *Ibid.* p. 8.

[162] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2003*, p. 15.

special circumstances of these new households.

Thus, the new group of potential homeowners will have unique needs. To tap this potential homeowner population, the mortgage industry will have to address these needs on several fronts, such as expanding education and outreach efforts, introducing new products, and adjusting current underwriting standards to better reflect the special circumstances of these new households.

The Bush administration has outlined a plan to expand minority homeownership by 5.5 million families by the end of the decade. The Joint Center for Housing Studies has stated that if favorable economic and housing market trends continue, and if additional efforts to target mortgage lending to low-income and minority households are made, the overall homeownership rate could reach 70 percent by 2010.[163]

7. Automated Underwriting Systems and Mortgage Scorecards

This, and the following two sections, discuss special topics that have impacted the primary and secondary mortgage markets in recent years. They are automated mortgage scoring, subprime loans, and risk-based pricing. The GSEs' use of automated underwriting and mortgage scoring systems was briefly discussed in the earlier section on underwriting standards. This section expands on issues related to automated underwriting, a process that has spread throughout the mortgage landscape over the past five years, due mainly to the efforts of Fannie Mae and Freddie Mac.

Automated mortgage scoring was developed as a high-tech tool with the purpose of identifying credit risks in a more efficient manner. Automated mortgage scoring has grown as competition and decreased profit margins have created demands to reduce loan origination costs. As a result, automated mortgage scoring has become the predominant (around 60 to 70 percent) mortgage underwriting method. [164]

According to Freddie Mac economists, automated mortgage scoring has enabled lenders to expand homeownership opportunities, particularly for underserved populations.[165] There is growing evidence that automated mortgage scoring is more accurate than manual underwriting in predicting borrower risks. Mortgage scorecards express the probability that an applicant will default as a function of several underwriting variables such as the level of down payment, monthly-payment-to-income ratios, cash reserves, and various indicators of an applicant's creditworthiness or credit history. Mortgage scorecards are statistically estimated regression-type equations, based on historical relationships between mortgage foreclosures (or defaults) and the underwriting variables. The level of down payment and credit history indicators, such as a FICO score, are typically the most important predictors of default in mortgage scoring systems.

For example, HUD has developed FHA TOTAL Scorecard to evaluate the credit risk of FHA loans submitted to an automated underwriting system. The Scorecard works with Fannie Mae's Desktop Underwriter® to provide a recommended level of underwriting and documentation for FHA loans and to determine a loan's eligibility for insurance with FHA. In 2003, Fannie Mae conducted a market test of the Scorecard with 18 FHA approved Desktop Underwriter® lenders. Over 3,000 loans were submitted to the Total Scorecard through Desktop Underwriter® during the market test period.[166]

This increased accuracy in risk assessment of mortgage scorecards has allowed risk managers to set more lenient risk standards, and thus originate more loans to marginal applicants. Applicants who would otherwise be rejected by manual underwriting are being qualified for mortgages with automated mortgage scoring in part because the scorecard allows an applicant's weaker areas to be offset by stronger characteristics. Typically, applicants whose projected monthly debt payment (mortgage payment plus credit card payment plus automobile loan payment and so on) comprise a high percentage of their monthly income would be turned down by a traditional underwriting system that relied on fixed debt-to-income ratios (such as 36 percent). In a mortgage scoring system, these same applicants might be automatically accepted for a loan due to their stellar credit record or to their ability to raise more cash for a down payment. The entity funding or insuring the mortgage (*i.e.*, a lender, private mortgage insurer, or a GSE) allows these positive characteristics to offset the negative characteristics because its confidence in the ability of the empirically-based mortgage scorecard to accurately identify those applicants who are more likely or less likely to eventually default on their loan. The mortgage score is in essence a recommendation to the lender to accept the application, or to refer it for further review through manual underwriting. Accepted loans benefit from reduced document requirements and expedited processing.

In 2003, Fannie Mae conducted a study of automated underwriting systems and concluded that the production cost per loan decreased significantly as lenders moved automated underwriting closer to the point of sale. Specifically, retail lenders using an integrated automated underwriting system at the point of sale reported originations savings of more than $1,000 over manual underwriting.[167] Freddie Mac also reported that Loan Prospector reduces the average time lenders spend underwriting most loans and reduces origination costs by about an average of $650 or more per loan.[168] In addition, Freddie Mac analyzed about 1,000 loans originated in 1993 and 1994. Of the loans, manual underwriters rated 52 percent accept, compared to a Loan Prospector accept rate of 87 percent.[169] In total, Freddie Mac reports that innovations in the originations process, including automated underwriting, have reduced mortgage transaction costs by more than 70 percent between 1990 and 2003 from 1.87 points to 0.46 points—a decline of $1,410 per $100,000 borrowed.[170]

As explained above, automated mortgage scoring allows tradeoffs between risk factors to be quantified more precisely, providing the industry more confidence in ''pushing the envelope'' of acceptable expected default rates. The GSEs' willingness to offer low-down-payment programs was based on their belief that their scoring models could identify the more creditworthy of the cash-constrained applicants. The GSEs' new ''timely reward'' products for subprime borrowers (discussed later) are integrated with their mortgage scoring systems. Automated mortgage scoring presents the opportunity to remove discrimination from mortgage underwriting, to accept all applicants, and to bring fair, objective, statistically based competitive pricing, greatly reducing costs for all risk groups. Some institutions have sought to better model and automate marginal and higher-risk loans, which have tended to be more costly to underwrite and more difficult to automate.[171]

Along with the promise of benefits, however, automated mortgage scoring has raised concerns. These concerns are related to the possibility of disparate impact and the proprietary nature of the mortgage score inputs. The first concern is that low-income and minority homebuyers will not score well enough to be accepted by the automated underwriting system, resulting in their getting fewer loans. African-American and Hispanic borrowers, for example, tend to have a poorer credit history record than other borrowers, which means they are more likely to be referred (rather than automatically accepted) by automated mortgage scoring systems that rely heavily on credit history measures such as a FICO score. There is also a significant statistical relationship between credit history scores and the minority composition of an area, after controlling for other locational characteristics.[172]

The second concern relates to the ''black box'' nature of the scoring algorithm. The scoring algorithm is proprietary and therefore

[163] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1998*, p. 20.

[164] John W. Straka, ''A Shift in the Mortgage Landscape: The 1990s Move to Automated Credit Evaluations,'' *Journal of Housing Research*, 2000, (11)2: p. 207.

[165] Peter M. Zorn, Susan Gates, and Vanessa Perry, ''Automated Underwriting and Lending Outcomes: The Effect of Improved Mortgage Risk Assessment on Under-Served Populations. Program on Housing and Urban Policy,'' *Conference Paper Series*, Fisher Center for Real Estate and Urban Economics. University of California Berkeley, 2001, p. 5.

[166] Fannie Mae, *2003 Annual Housing Activities Report*, 2004, p. 12.

[167] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, p. 36.

[168] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 55.

[169] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 54.

[170] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 5.

[171] *Ibid.* pp. 208–217.

[172] Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner, *Credit Scoring: Issues and Evidence from Credit Bureau Files,* mimeo, 1998, p. 24.

it is difficult for applicants to know the reasons for their scores. However, it should be noted that the GSEs have taken steps to make their automated underwriting systems more transparent. Both Fannie Mae and Freddie Mac have published the factors used to make loan purchase decisions in Desktop Underwriter and Loan Prospector, respectively. In response to criticisms aimed at using FICO scores in mortgage underwriting, Fannie Mae's new versions of Desktop Underwriter (DU) 5.3 and 5.3.1 [the newest versions are 5.3 and 5.3.1—they probably keep the following practices, but add no substantive underwriting practices, but rather lower downpayment options] replaces credit scores with specific credit characteristics and provides expanded approval product offerings for borrowers who have blemished credit. The specific credit characteristics include variables such as past delinquencies; credit records, foreclosures, and accounts in collection; credit card line and use; age of accounts; and number of credit inquiries.[173]

With automated mortgage scoring replacing traditional manual underwriting comes the fear that the loss of individual attention poses a problem for people who have inaccuracies on their credit report or for members of cultural groups or recent immigrants who do not use traditional credit and do not have a credit score. Some subprime lenders and underwriters have claimed that their manual underwriting of high-risk borrowers cannot be automated with mortgage scoring. Although automated mortgage scoring has greatly reduced the cost of many lower-risk loans that are easier to rate, the cost of manually underwriting gray-area and higher-risk applicants still remains high.[174] There is also the fear that applicants who are referred by the automated system will not be given the full manual underwriting for the product that they initially applied for—rather they might be pushed off to higher priced products such as a subprime or FHA loan. In this case, the applicant may have had special circumstances that would have been clarified by the traditional manual underwriting, thus enabling the applicant to receive a prime loan consistent with his or her creditworthiness.

Banking regulators and legal analysts acknowledge the value of automated mortgage scoring, although some skeptics have noted concerns regarding fair lending, potential fraud, privacy issues, and the ability of models to withstand changing economic conditions.[175] With the rise of automated mortgage scoring, the great difference in Internet usage known as the ''digital divide'' could result in informational disadvantages for less educated and lower-income consumers. In addition to the digital divide, the lack of financial literacy in the United States may also result in a disparate impact on low-income and minority borrowers.[176]

2002 Urban Institute Study. The Urban Institute submitted a report to HUD in 2002 on subprime markets, the role of GSEs, and risk-based pricing.[177] The study took a preliminary look at the use of automated underwriting systems for a small sample of lenders. After conducting interviews with both subprime and prime lenders, the report noted that all of the lenders in the study had implemented some type of automated underwriting system. These lenders stated that automated underwriting raised their business volume and streamlined their approval process. In addition, the lenders reported they were able to direct more underwriting resources to borderline applications despite an increase in business volume.

Even with the use of automated mortgage scoring, the lenders in the study continued to conduct at least a cursory review to validate the application material. The majority of the lenders still used manual underwriting to originate loans not recommended for approval with automated mortgage scoring. The lenders reported they formulated their policies and procedures to make certain that borrowers receive the best mortgage, according to product eligibility. This study will be further referenced in a following section regarding subprime markets.

2001 Freddie Mac Study. According to a Freddie Mac study published by the Fisher Center for Real Estate and Urban Economics at University of California at Berkeley, underserved populations have benefited from automated mortgage scoring because of the increased ability to distinguish between a range of credit risks. In this paper, Freddie Mac economists compared the manual and automated mortgage scoring approval rates of a sample of minority loans originated in 1993–94 and purchased by Freddie Mac. While manual underwriters rated 51 percent of the minority loans in the sample as accept, automated mortgage scoring would have rated 79 percent of the loans as accept. [178]

In comparison to manual underwriting, this study found automated mortgage scoring not only less discriminatory but also more accurate in predicting risk. Two versions of Freddie Mac's automated underwriting system, Loan Prospector (LP), were used to review three groups of mortgage loans purchased by Freddie Mac.[179] The study found that LP was a highly accurate predictor of mortgage default. The resulting improved accuracy translates into benefits for borrowers, who would otherwise be rejected by manual underwriting to qualify for mortgages.

Analysis of the first group of loans showed that loans rated as ''caution'' were four times more likely to default than the average for all loans. Minority borrowers whose loans were rated as ''caution'' were five times more likely to default, and low-income borrowers whose loans were rated as ''caution'' were four times more likely to default than the average for all loans. The 2000 version of LP approved 87.1 percent of loans generated through affordable housing programs, compared to a 51.6 percent approval rate when the same loans were assessed using manual underwriting procedures. Further, the study found LP more accurate than manual underwriting at predicting default risk even with a higher approval rate. The study also demonstrated that Freddie Mac's year 2000 version of LP was more accurate in predicting risk than its 1995 version.

Concluding Observations. Automated underwriting has enabled lenders to reach new markets and expand homeownership opportunities, as illustrated by the 2001 Freddie Mac study. Increased accuracy with automated mortgage scoring has led to the development of new mortgage products that would have been previously considered too risky. For example, Freddie Mac uses Loan Prospector to approve Alt A loans, which tend to have nontraditional documentation; A-minus loans, which pose a higher risk of default; and other higher-risk mortgages, like 100 percent LTV loans. Both GSEs have and continue to add new products to develop their automated underwriting systems to reach more marginal borrowers.

Despite the gains in automated mortgage scoring and other innovations, minorities are still less likely to be approved for a loan. The difference in minority and non-minority accept rates may reflect greater social inequities in financial capacity and credit, which are integral variables in both manual and automated underwriting. In the future, the accuracy of automated mortgage scoring will hinge on updating the models and making them more predictive while reducing the disparate impact on low-income and minority borrowers.[180] The fairness of automated scoring systems will also depend importantly on whether referred applicants receive a traditional manual underwriting for the loan that they initially applied for, rather than being immediately offered a higher priced loan that does not recognize their true creditworthiness.

In addition to using automated underwriting systems as a tool to help determine whether a mortgage application should be approved, the GSEs' automated underwriting systems are being further adapted to facilitate risk-based pricing. With risk-based pricing, mortgage lenders can offer each borrower an individual rate based on his or her risk. The division between the subprime and the prime mortgage market will begin to fade with the rise of risk-based pricing, which is discussed in the next section on the subprime market.

[173] Fannie Mae, September 4, 2002, p. 33.

[174] Kenneth Temkin, Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing,* Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

[175] Allen J. Fishbein, ''Is Credit Scoring a Winner for Everyone?'' *Stone Soup,* 2000, 14(3): pp. 14–15. See also Fitch IBCA, Inc., *Residential Mortgage Credit Scoring,* New York, 1995 and Jim Kunkel, ''The Risk of Mortgage Automation,'' in *Mortgage Banking,* 1995, 57(8): pp. 69–76.

[176] Zorn et al., 2001, pp. 19–20.

[177] Kenneth Temkin, Jennifer E.H. Johnson, and Diane Levy, *Subprime Markets, The Role of GSEs, and Risk-Based Pricing,* Washington: The Urban Institute. Report Prepared for the U.S. Department of Housing and Urban Development, 2002.

[178] Zorn, et al., 2001, pp. 14–15.

[179] *Ibid.* p. 5.

[180] *Ibid.* pp. 18–19.

8. Subprime Lending

The subprime mortgage market provides mortgage financing to credit-impaired borrowers—those who may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. This section examines several topics related to subprime lending including (a) the growth and characteristics of subprime loans, (b) the neighborhood concentration of subprime lending, (c) predatory lending, and (d) purchases of subprime mortgages by the GSEs. Section C.9 follows with a discussion of risk-based pricing.

a. The Growth and Characteristics of Subprime Loans

The subprime market has grown rapidly over the past several years, increasing from an estimated $35 billion in 1994 to $160 billion in 1999 and $173.3 billion in 2001, before rising to $213 billion in 2002. The subprime share of total market originations rose from 4.6 percent in 1994 to a high of 15 percent in 1999, and then fell to 8.5 percent in both 2001 and 2002.[181] Various factors have led to the rapid growth in the subprime market: Federal legislation preempting state restrictions on allowable rates and loan features, the tax reform act of 1986 which encouraged tax-exempt home equity financing of consumer debt, increased demand for and availability of consumer debt, a substantial increase in homeowner equity due to house price appreciation, and a ready supply of available funds through Wall Street securitization.[182] It is important to note that subprime lending grew in the 1990s mostly without the assistance of Fannie Mae and Freddie Mac.

Generally, there are three different types of products available for subprime borrowers. These include: Home purchase and refinance mortgages designed for borrowers with poor credit histories; ''Alt A'' mortgages that are usually originated for borrowers who are unable to document all of the underwriting information but who may have solid credit records; and high loan-to-value mortgages originated to borrowers with fairly good credit. Fannie Mae and Freddie Mac are more likely to serve the first two types of subprime borrowers.[183]

Borrowers use subprime loans for various purposes, which include debt consolidation, home improvements, and an alternative source of consumer credit. Between 1999 and 2001, about two-thirds of subprime loans were refinance loans. It has been estimated that 59 percent of refinance loans were ''cash out'' loans.[184] According to a joint HUD-Treasury report, first liens accounted for more than three out of four loans in the subprime market.

The subprime market is divided into different risk categories, ranging from least risky to most risky: A-minus, B, C, and D. While there are no clear industry standards for defining the subprime risk categories, Inside Mortgage Finance defines them in terms of FICO scores—580–620 for A-minus, 560–580 for B, 540–560 for C, and less than 540 for D. The A-minus share of the subprime market rose from 61.6 percent in 2000 to 70.7 percent in 2001.[185] For the first nine months of 2002, the A-minus share accounted for 74 percent of the market, while the B share accounted for 11 percent, the C share accounted for 7.2 percent, and the D share accounted for 7.9 percent of the market.[186]

Delinquency rates by type of subprime loan are as follows: 3.36 percent for A-minus loans, 6.67 percent for B, 9.22 percent for C, and 21.03 percent for D, according to the Mortgage Information Corporation.[187] Because of their higher risk of default, subprime loans typically carry much higher mortgage rates than prime mortgages. Recent quotes for a 30-year Fixed Rate Mortgage were 8.85 percent for A-minus (with an 85 percent LTV), 9.10 percent for B credit (with an 80 percent LTV), and 10.35 percent for C credit (with a 75 percent LTV).[188] As the low loan-to-value (LTV) ratios indicate, one loss mitigation technique used by subprime lenders is a high down payment requirement. Some housing advocates have expressed concern that the perceptions about the risk of subprime loans may not always be accurate, for example, creditworthy borrowers in inner city neighborhoods may be forced to use subprime lenders because mainstream lenders are not doing business in their neighborhoods (see below).

Subprime borrowers are much more likely to be low income and be a minority than other borrowers. Between 1999 and 2001, 43.1 percent of subprime loans in the conventional conforming market went to low-income borrowers, compared with 29.5 percent of conventional conforming loans. During that same period, 19.9 percent of subprime loans were for African-American borrowers, compared with 6.5 percent of all conventional conforming loans. However, what distinguishes subprime loans from other loans is their concentration in African-American neighborhoods.

b. The Neighborhood Concentration of Subprime Lending

The growth in subprime lending over the last several years has benefited credit-impaired borrowers as well as those borrowers who choose to provide little documentation for underwriting. However, studies showing that subprime lending is disproportionately concentrated in low-income and minority neighborhoods have raised concerns about whether mainstream lenders are adequately serving these neighborhoods. A study of subprime lending in Chicago by The Woodstock Institute concluded that a dual, hyper-segmented mortgage market existed in Chicago, as mainstream lenders active in white and upper-income neighborhoods were much less active in low-income and minority neighborhoods–effectively leaving these neighborhoods to unregulated subprime lenders.[189] As part of the HUD-Treasury Task Force on Predatory Lending, HUD's Office of Policy Development and Research released a national level study—titled *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*—that showed families living in low-income and African-American neighborhoods in 1998 relied disproportionately on subprime refinance lending, even after controlling for neighborhood income. An update of that analysis for the year 2000 yields the following trends:[190]

- In 2000, 36 percent of refinance mortgages in low-income neighborhoods were subprime, compared with only 16 percent in upper-income neighborhoods.
- Subprime lending accounted for 50 percent of refinance loans in majority African American neighborhoods—compared with only 21 percent in predominantly white areas (less than 30 percent of population is African American).
- The most dramatic view of the disparity in subprime lending comes from comparing homeowners in upper-income African-American and white neighborhoods. Among homeowners living in the upper-income white neighborhoods, only 16 percent turned to subprime lenders in 2000. But 42 percent of homeowners living in upper-income African-American neighborhoods relied upon subprime refinancing which is substantially more than the rate (30 percent) for homeowners living in low-income white neighborhoods.
- Similar results are obtained when the analysis is conducted for borrowers instead of neighborhoods. Upper-income African-American borrowers are twice as likely as low-income white borrowers to have subprime loans. Over one-half (54 percent) of

[181] Subprime origination data are from Inside Mortgage Finance. For the 2002 estimates, see ''Subprime Origination Market Shows Strong Growth in 2002,'' *Inside B&C Lending,* published by Inside Mortgage Finance, February 3, 2003, page 1.

[182] Temkin et. al., 2002, p. 1.

[183] Kenneth Temkin, Jennifer E.H. Johnson, Diane Levy, *Subprime Markets, The Role of GSEs, and Risk Based Pricing,* Washington: The Urban Institute. Report Prepared for the Department of Housing and Urban Development, 2002, p. 4.

[184] U.S. Department of Housing and Urban Development/U.S. Department of the Treasury, *Curbing Predatory Lending Report,* 2000, p.31.

[185] ''Wholesale Dominates Subprime Market Through 3rd Quarter '02,'' *Inside B&C Lending,* published by Inside Mortgage Finance, December 16, 2002, pp. 1–2.

[186] *Inside B&C Lending,* November 16, 2002, p.2.

[187] Mortgage Information Corporation, *The Market Pulse*, Winter 2001, pp. 4–6.

[188] *Inside B&C Lending,* published by Inside Mortgage Finance, February 17, 2003, page 13.

[189] Daniel Immergluck, *The Predatory Lending Crisis in Chicago: The Dual Mortgage Market and Local Policy,* testimony before the Chicago City Council, April 5, 2000. Immergluck found that subprime lenders received 74 percent of refinance applications in predominantly black tracts compared to 21 percent in predominantly white tracts in 1998. According to Immergluck, these racial disparities provide evidence that the residential finance market in Chicago is hypersegmented, resulting in the increased likelihood that minorities receive mortgage credit from a subprime, rather than a prime, lender in Chicago. Also see Daniel Immergluck, *Stark Differences: The Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending,* Woodstock Institute, October 2000

[190] See Randall M. Scheessele, *Black and White Disparities in Subprime Mortgage Refinance Lending,* Housing Finance Working Paper HF–014, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, April 2002.

low-income African-American borrowers turn to subprime lenders, as does over one-third (35 percent) of upper-income African-American borrowers. By comparison, only 24 percent of low-income white borrowers and 12 percent of upper-income white borrowers, rely upon subprime lenders for their refinance loans.[191]

It does not seem likely that these high market shares by subprime lenders in low-income and African-American neighborhoods can be justified by a heavier concentration of households with poor credit in these neighborhoods. Rather, it appears that subprime lenders may have attained such high market shares by serving areas where prime lenders do not have a significant presence. The above finding that upper-income black borrowers rely more heavily on the subprime market than low-income white borrowers suggests that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. A lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these communities are paying a high cost for credit. As explained next, there is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear. Thus, a greater presence by mainstream lenders could possibly reduce the high up-front fees and interest rates being paid by residents of low-income and minority neighborhoods.

The Freddie Mac study presented evidence that subprime loans bear interest rates that are higher than necessary to offset the higher credit risks of these loans.[192] The study compared (a) the interest rate on subprime loans rated A-minus by the lenders originating these loans with (b) the interest rates on prime loans purchased by Freddie Mac and rated A-minus by a Freddie Mac underwriting model. Despite the fact that both loan groups were rated A-minus, on average the subprime loans bore interest rates that were 215 basis points higher. Even assuming that the credit risk of the subprime loans was in fact higher than the prime loans, the study could not account for such a large discrepancy in interest rates. Assuming that default rates might be three to four times higher for the subprime loans would account for a 90 basis point interest rate differential. Assuming that servicing the subprime loans would be more costly would justify an additional 25 basis point differential. But even after allowing for these possible differences, the Freddie Mac researchers concluded that the subprime loans had an unexplained interest rate premium of 100 basis points on average.[193]

Banking regulators have recognized the link between the growth in subprime lending and the absence of mainstream lenders and have urged banks and thrifts that lending in these neighborhoods not only demonstrates responsible corporate citizenship but also profitable lending. Ellen Seidman, former Director of the Office of Thrift Supervision, stated that, ''Many of those served by the subprime market are creditworthy borrowers who are simply stuck with subprime loans or subprime lenders because they live in neighborhoods that have too few credit or banking opportunities.''

With respect to the question of whether borrowers in the subprime market are sufficiently creditworthy to qualify for more traditional loans, Freddie Mac has said that one of the promises of automated underwriting is that it might be better able to identify borrowers who are unnecessarily assigned to the high-cost subprime market. Freddie Mac has estimated that 10–30 percent of borrowers who obtain mortgages in the subprime market could qualify for a conventional prime loan through Loan Prospector, Freddie Mac's automated underwriting system.[194] Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae.[195]

c. Predatory Lending

Predatory lending has been a disturbing part of the growth in the subprime market. Although questions remain about its magnitude, predatory lending has turned homeownership into a nightmare for far too many households. The growing incidence of abusive practices has been stripping borrowers of their home equity, threatening families with foreclosure, and destabilizing neighborhoods. Also, in some cities, there are indications that unscrupulous realtors, mortgage brokers, appraisers, and lenders are duping some FHA borrowers into purchasing homes at an inflated price or with significant undisclosed repairs. The problems associated with home equity fraud and other mortgage abuses are not new ones, but the extent of this activity seems to be increasing. The expansion of predatory lending practices along with subprime lending is especially troubling since subprime lending is disproportionately concentrated in low- and very-low income neighborhoods, and in African-American neighborhoods.

The term ''predatory lending'' is a short hand term that is used to encompass a wide range of abuses. While there is broad public agreement that predatory lending should have no place in the mortgage market, there are differing views about the magnitude of the problem, or even how to define practices that make a loan predatory. The joint HUD-Treasury report, *Curbing Predatory Home Mortgage Lending*, concluded that a loan can be predatory when lenders or brokers: charge borrowers excessive, often hidden fees (called ''packing fees''); successively refinance loans at no benefit to the borrower (called ''loan flipping''); make loans without regard to a borrower's ability to repay; and, engage in high-pressure sales tactics or outright fraud and deception. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices. Vulnerable populations, including the elderly and low-income individuals, and low-income or minority neighborhoods, appeared to be especially targeted by unscrupulous lenders.

One consequence of predatory lending is that borrowers are stripped of the equity in their homes, which places them at an increased risk of foreclosure. In fact, high foreclosure rates for subprime loans provide the most concrete evidence that many subprime borrowers are entering into mortgage loans that they simply cannot afford. The high rate of foreclosures in the subprime market has been documented by HUD and others in recent research studies.[196] These studies have found that foreclosures by subprime lenders grew rapidly during the 1990s and now exceed the subprime lenders' share of originations. In addition, the studies indicate that foreclosures of subprime loans occur much more quickly than foreclosures on prime loans, and that they are concentrated in low-income and African-American neighborhoods. Of course, given the riskier nature of these loans, a higher foreclosure rate would be expected. With the information available it is not possible to evaluate whether the disparities in foreclosure rates are within the range of what would be expected for loans prudently originated within this risk class. But findings from these studies about the high rate of mortgage foreclosure associated with subprime lending reinforce the concern that predatory lending can potentially have devastating effects for individual families and their neighborhoods.

At this time, there are open questions about the effectiveness of the different approaches being proposed for eradicating

[191] For an update to 2001, *see* The Association of Community Organizers for Reform Now (ACORN), *Separate and Unequal Predatory Lending in America*, 2002. In 2001, subprime lenders originated 27.8 percent of all conventional refinance loans for African-Americans, 13.6 percent for Hispanic homeowners, and just 6.3 percent for white homeowners. Overall, African-Americans were 4.4 times more likely to use a subprime lender than whites, and Hispanics were 2.2 times more likely to do so.

[192] Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, ''Subprime Lending: An Investigation of Economic Efficiency,'' February 25, 2000.

[193] It should also be noted that higher interest rates are only one component of the higher cost of subprime loans since borrowers also often face higher origination points. The Freddie Mac study did not find a large differential between prime and subprime loans in points paid, but the study notes that subprime loans often have points rolled into the loan principal, which cannot be identified with their data.

[194] Freddie Mac, *We Open Doors for America's Families*, Freddie Mac's Annual Housing Activities Report for 1997, March 16, 1998, p. 23.

[195] Rommy Fernandez, ''Fannie Mae Eyes Half of the Subprime Market,'' in *The American Banker*, March 1, 2002. Also *see* ''Fannie Mae Vows More Minority Lending,'' *Washington Post*, March 16, 2000, p. EO1.

[196] For an overview of these studies, see Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, Randall M. Scheessele, *Subprime Foreclosures: The Smoking Gun of Predatory Lending*, 2000. Also see Abt Associates Inc., *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metro Area,* February 2000 and *Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Boston Metro Area*, September 2000; National Training and Information Center, *Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures*, 2000; and the HUD study, *Unequal Burden in Baltimore: Income and Racial Disparities in Subprime Lending*, May 2000.

predatory lending and the appropriate roles of different governmental agencies—more legislation versus increased enforcement of existing laws, long-run financial education versus mortgage counseling, Federal versus state and local actions. In its recent issuance of predatory lending standards for national banks, the Office of the Comptroller of the Currency (OCC) cited the efforts of Fannie Mae and Freddie Mac in reducing predatory lending.[197] The OCC advised banks against abusive practices, such as rolling single-premium life insurance into a loan. The agency cited guidelines developed by Fannie Mae and Freddie Mac as a ''useful reference'' or starting point for national banks. Following publication of HUD's proposed 2000 Rule inviting comments on disallowing goals credit for high cost mortgage loans, Fannie Mae and Freddie Mac told lenders they would no longer purchase loans with certain abusive practices, such as excessive fees and failing to consider a borrower's ability to repay the debt.

It is important to re-emphasize that predatory lending generally occurs in neighborhoods where borrowers have limited access to mainstream lenders. While predatory lending can occur in the prime market, it is ordinarily deterred in that market by competition among lenders, greater homogeneity in loan terms and greater financial information among borrowers. Thus, one solution to address this problem would be to encourage more mainstream lenders to do business in our inner city neighborhoods.

Certain commenters urged the Department to adopt predatory lending safeguards in the final rule that would prohibit the GSEs from counting loans that included mandatory arbitration clauses or loans with prepayment penalties beyond three years towards the goals. In the 2000 rulemaking, the Department determined that the GSEs should not receive goals credit for purchasing high cost mortgages including mortgages with unacceptable features as explained in the preamble. The Department is aware that certain practices that were not enumerated in the regulations adopted in 2000, such as loans with prepayment penalties after three years and loans with mandatory arbitration clauses, often lock borrowers into disadvantageous loan products. The Department will rely on existing regulatory authorities to monitor the GSEs' performance in this area. Should the Department later determine that there is a need to specifically enumerate additional prohibited predatory practices, it will address such practices in a future rulemaking.

d. Purchases of Subprime Mortgages by the GSEs

Fannie Mae and Freddie Mac have shown increasing interest in the subprime market since the latter half of the 1990s. The GSEs entered this market by purchasing securities backed by non-conforming loans. Freddie Mac, in particular, increased its subprime business through structured transactions, with Freddie Mac guaranteeing the senior classes of senior/subordinated securities. The two GSEs also purchase subprime loans on a flow basis. Fannie Mae began purchasing subprime loans through its Timely Payment Reward Mortgage program in June 1999, and Freddie Mac rolled out a similar product, Affordable Merit Rate, in May 2000 (described below). In addition to purchasing subprime loans for borrowers with blemished credit, the GSEs also purchase another non-conforming loan called an Alternative-A or ''Alt-A'' mortgage. These mortgages are made to prime borrowers who do not want to provide full documentation for loans. The GSEs' interest in the subprime market has coincided with a maturation of their traditional market (the conforming conventional mortgage market), and their development of mortgage scoring systems, which they believe allows them to accurately model credit risk. Although the GSEs account for only a modest share of the subprime market today, some market analysts estimate that they could purchase as much as half of the overall subprime market in the next few years.[198]

Precise information on the GSEs' purchases of subprime loans is not readily available. Data can be pieced together from various sources, but this can be a confusing exercise because of the different types of non-conforming loans (Alt-A and subprime) and the different channels through which the GSEs purchase these loans (through securitizations and through their ''flow-based'' product offerings). Freddie Mac, which has been the more aggressive GSE in the subprime market, purchased approximately $12 billion in subprime loans during 1999—$7 billion of A-minus and alternative-A loans through its standard flow programs and $5 billion through structured transactions.[199] In 2000, Freddie Mac purchased $18.6 billion of subprime loans on a flow basis in addition to another $7.7 billion of subprime loans through structured transactions.[200] Freddie Mac securitized $9 billion in subprime and Alt-A product in 2001 and $11.1 billion in 2002.

Fannie Mae's anti-predatory lending strategy includes eight major components. These components include: establishing business guidelines that ensure that liquidity is provided for only responsible lenders; expanding the application of conventional conforming mortgage practices to more borrowers; advancing the Mortgage Consumer Bill of Rights Agenda; offering a broad range of alternative responsible products; leveraging technology and the Internet to expand markets and reduce costs for consumers; working with partners to keep borrowers in their homes; supporting the home-buyer education industry to empower educators to reach more consumers; and supporting the Fannie Mae Foundation in consumer education and outreach.[201]

In recent years, Freddie Mac has instituted measures designed to protect consumers from predatory lending. For example, Freddie Mac has announced that, effective August 1, 2004, they will no longer invest in subprime mortgages originated after that date that contain mandatory arbitration clauses. Since 2000, Freddie Mac has prohibited purchases of mortgages that impose a prepayment premium for a term of more than five years, and in March 2002, this prohibition was reduced to no more than three years. Freddie Mac does not purchase high-rate or high-fee loans that are covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA); and they do not purchase mortgages containing a prepaid single-premium credit life, credit disability, credit unemployment or credit property insurance policy. Freddie Mac also requires all lenders servicing their loans to report monthly borrower mortgage payments to all four major credit repositories, and conducts onsite reviews of their customers and holds them accountable if their business practices do not meet Freddie Mac standards.[202]

Fannie Mae initiated its Timely Payments product in September 1999, under which borrowers with slightly damaged credit can qualify for a mortgage with a higher interest rate than prime borrowers. Under this product, a borrower's interest rate will be reduced by 100 basis points if the borrower makes 24 consecutive monthly payments without a delinquency. Fannie Mae has revamped its automated underwriting system (Desktop Underwriter) so loans that were traditionally referred for manual underwriting are now given four risk classifications, three of which identify potential subprime (A-minus) loans.[203] Fannie purchased about $600 million of subprime loans on a flow basis in 2000.[204] Fannie Mae securitized around $0.6 billion in subprime mortgages in 2000, before increasing to $5.0 billion in 2001 and 7.3 billion in 2002.[205] In terms of total subprime activity (both flow and securitization activities), Fannie Mae purchased $9.2 billion in 2001 and over $15 billion in 2002, the latter figure representing about 10 percent of the market, according to Fannie Mae staff.[206]

A greater GSE role in the subprime lending market will most likely have a significant impact on the subprime market. Currently, the majority of subprime loans are not purchased by GSEs, and the numbers of lenders originating subprime loans typically do not issue a large amount of prime loans. Partly in response to higher affordable

[197] ''OCC Cites Fannie, Freddie Predatory Lending Rules As Model,'' Dow Jones Business News, February 25, 2003.

[198] Temkin *et al.*, 2002, p. 1.

[199] David A. Andrukonis, ''Entering the Subprime Arena,'' *Mortgage Banking,* May 2000, pp. 57–60.

[200] Subprime Lenders Mixed on Issue of GSE Mission Creep,'' Inside B and C Lending, March 19, 2001.

[201] Fannie Mae, ''Fannie Mae's Comments on HUD's Proposed Housing Goals for Fannie Mae and Freddie Mac for the years 2005–2008 and Amendments to HUD's Regulation of Fannie Mae and Freddie Mac,'' July 16, 2004, p. I–59.

[202] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p. 6.

[203] See Lederman, *et al.*, *Op cit.*

[204] Kenneth Temkin, Jennifer E. H. Johnson, and Diane K. Levy, ''Subprime Markets, the Role of GSEs, and Risk-Based Pricing,'' *Urban Institute*, August 2001, p. 1.

[205] *Inside Mortgage Finance's,* ''Inside MBS & ABS,'' December 15, 2000 and March 8, 2002.

[206] Statement by Mercy Jimenez of Fannie Mae in ''Fannie Mae: Forges Ahead in Subprime,'' *Secondary Marketing Executive*, February 2003, p.15.

housing goals set by HUD in its new rule set in 2000, the GSEs are increasing their business in the subprime market. In the 2000 GSE Rule, HUD identified subprime borrowers as a market that can assist Fannie Mae and Freddie Mac in reaching their higher affordable housing goals while also helping establish more standardization in the subprime market. According to an Urban Institute study in 2002, many subprime lenders believe that successful companies serving high-risk borrowers need to have specialized expertise in outreach, servicing, and underwriting, which is lacking among most prime lenders.[207] These lenders do not believe the more standardized approaches of prime lenders and the GSEs will work with subprime borrowers, who require the more customized and intensive origination and loan servicing processes currently offered by experienced subprime lenders.

As noted above, both Fannie Mae and Freddie Mac make the claim that the subprime market is inefficient, pointing to evidence indicating that subprime borrowers pay interest rates, points, and fees in excess of the increased costs associated with serving riskier borrowers in the subprime market.[208] A recent Freddie Mac study found automated mortgage scoring less discriminatory and more accurate in predicting risk than manual systems such as those currently used by subprime lenders.[209] According to Fannie Mae, although a high proportion of borrowers in the subprime market could qualify for less costly prime mortgages, it remains unclear why these borrowers end up in the subprime market.[210] Fannie Mae and Freddie Mac believe they can bring more efficiency to the subprime market by creating standardized underwriting and pricing guidelines in the subprime market. An expanded GSE presence in the subprime market could be of significant benefit to lower-income and minority families if it attracted more mainstream lenders and competition to those inner-city neighborhoods that are currently served mainly by subprime lenders.

Several commenters indicated that to obtain the higher housing goals the GSEs would increase their purchasing of subprime loans. While some industry commenters welcome the entrance of the GSEs into the subprime market because their presence brings stability and standardizes business practices, they are concerned that unrealistically high goals could force the GSEs to jump into the market in a manner that negatively distorts underwriting and pricing. These commenters report that the GSEs can bring capital and standards but must gradually and carefully enter the subprime market in order to have a positive effect.

In the past, Fannie Mae and Freddie Mac have voluntarily decided not to purchases subprime loans with features such as single-premium life, HOEPA loans, and prepayment penalty terms that exceed three years. Freddie Mac indicated that the increased goals would limit its ability to influence subprime lending practices.

Several commenters suggest that if the GSEs are pushed to serve more of the subprime market, they will skim a significant portion of the lower-risk borrowers from that market. The resulting smaller subprime market would be comprised of the neediest borrowers. Concerned was raised by commenters that these higher risk borrowers would pay more based on three factors. First lower risk borrowers would not be present to subsidize them. Second, the market's high fixed costs would be distributed across fewer borrowers. Finally, a significantly smaller subprime market for private lenders would drive some lenders out of business translating into less competition.

9. Risk-Based Pricing

The expanded use of automated underwriting and the initial uses of risk-based pricing are changing the mortgage lending environment, often blurring the distinctions between the prime and subprime market. Prime lenders are now using automated underwriting systems that are being adapted to facilitate risk-based pricing. For some time, the majority of prime mortgage borrowers have received loan rates based on average cost pricing. Generally, borrowers receive roughly the same Annual Percentage Rate[211] (APR), regardless of the risk of loss to the lender. The risk of all borrowers is averaged together, and the price is determined by the average risk.

In contrast, risk-based pricing enables mortgage lenders to offer each borrower an individualized interest rate based on his or her risk. Or, more broadly, to offer interest rates based on whether or not the borrower falls into a certain category of risk, such as specific loan-to-value and FICO score combination or specified mortgage score range. Lenders could also set the interest rate based on various factors including the probability of prepayment and characteristics of the underlying collateral, as well as the default risk of the borrower. Borrowers that pose a lower risk of loss to the lender would then be charged a comparatively lower rate than those borrowers with greater risk. Rather than lower risk borrowers cross-subsidizing higher risk borrowers like in average cost pricing, lower risk borrowers pay a relatively lower rate.

In response to the expanded use of automated underwriting and pressures from the GSEs, other purchasers of loans, mortgage insurers, and rating firms, lenders are increasing their use of risk-based pricing.[212] In today's markets, some form of differential pricing exists for the various subprime categories, for new products targeted at credit-impaired borrowers (such as Fannie Mae's Timely Payments product), and for private mortgage insurance across all credit ranges. For example, private mortgage insurers use FICO scores and ''Accept'' determinations from the GSEs'' automated underwriting systems to make adjustments to insurance premiums.[213] Rating agencies vary subordination requirements based on the credit qualify of the underlying collateral.

Many believe there is cross-subsidization within the crude risk categories used in today's market. For example, some of the better quality subprime borrowers in the A-minus category may be inappropriately assigned to the subprime market. The GSEs and others are attempting to learn more about the subprime market, and their initial efforts suggest that there will be an increase in the use of risk-based pricing within this market, although it is recognized that the expansion of risk-based pricing depends importantly on these parties gaining a better understanding of the subprime borrower and the ability of their mortgage scoring systems to predict risk within this market. It must be noted that the power of the underlying algorithm in automated underwriting systems determines the ability of these systems to accurately predict risk and set prices.

If prime lenders adopted risk-based pricing, many would be willing to lend to riskier subprime borrowers because their risk would now be offset with an increase in price. In theory, the mortgage market should expand because all mortgages will be approved at a price commensurate with risk, rather than setting a risk floor and approving no one beneath the floor. Risk-based pricing could also expand the prime lenders' market by enabling them to reach a new group of underserved customers.[214] Taking advantage of GSEs' lower cost of capital, GSEs may be able to offer borrowers who could not afford a rate in the subprime market a rate they can afford resulting from risk-based pricing.

Risk-based pricing also poses challenges on the mortgage market because some of the more risky borrowers (who are currently cross-subsidized by less risky borrowers) may not be able to afford their higher, risk-based interest rate. Also, the adoption of an automated risk-based pricing system may have an uncertain effect on minority groups, who tend to have lower credit scores, as discussed earlier. On the other hand, if minorities are eligible for prime financing, the cost of financing minorities may fall as will the potential for subprime lenders to draw minorities to their higher-priced products.

As the GSEs become more comfortable with subprime lending, the line between what today is considered a subprime loan versus a prime loan will likely deteriorate, making expansion by the GSEs look more like an increase in the prime market. This melding of markets could occur even if many of the underlying characteristics of subprime borrowers and the market's evaluation of the risks posed by these borrowers remain unchanged. Increased involvement by the GSEs in the subprime market will result in more standardized underwriting guidelines and the increased participation of traditional lenders. In fact, there are indications that mainstream players are already increasing

[207] Temkin *et al.*, 2002, p. 1.

[208] See Lax *et al.*, 2000.

[209] Zorn, *et al.*, 2001, p. 5.

[210] Fannie Mae, Remarks Prepared for Delivery by Franklin Raines, Chairman and CEO of Fannie Mae to the National Community Reinvestment Coalition. Washington, D.C. March 20, 2000.

[211] Annual Percentage Rate takes into account points, fees, and the periodic interest rate.

[212] Temkin et al., 2002, p.29.

[213] For example, see Radian's product offerings at http://www.radiangroupinc.com.

[214] Vanessa Bush, ''Risk-Based Pricing Trend Could Make Mortgage Lending More Efficient,'' *America's Community Banker*, October 1, 1998.

their activity in this market. According to staff from Moody's Investors Service, the growing role of large mortgage aggregators in the subprime market has been a key factor in the improving credit qualify on deals issued in 2002.[215] According to a representative from Washington Mutual, subprime credit qualify has also improved as lenders carve out new loan categories that fall somewhere between the large Alt A market and traditional subprime business.[216] As the subprime market becomes more standardized, market efficiencies will reduce borrowing costs. Lending to credit-impaired borrowers will, in turn, increasingly make good business sense for the mortgage market.

D. Factor 2: Economic, Housing, and Demographic Conditions: Multifamily Mortgage Market

1. Introduction

At the time of the previous GSE rulemaking in 2000, the multifamily rental housing market was coming off several years of generally positive performance. Vacancies were low in most markets and rent increases were matching or exceeding economy-wide inflation. A key to this strong performance was the volume of new multifamily construction, which was at a level consistent with demand growth. Job growth and income gains helped many renters pay the higher rents without undue burden. As always, conditions varied from region to region, and across market segments, but the overall tone of the apartment market was quite healthy.

Much has changed in the subsequent years. An economic slowdown reduced apartment demand, and with new multifamily construction about unchanged, vacancies rose and rents softened. Provision of decent housing affordable to households of moderate or low incomes is a challenge even in strong economic times, and with the unemployment rate rising above 6 percent before falling to about 5 and a half percent, affordability problems increased for many, despite the softness in rents.

Despite the recent weakness in the apartment property market, the market for financing of apartments has grown to record volumes. The favorable long-term prospects for apartment investments, combined with record low interest rates, has kept investor demand for apartments strong and supported property prices. Refinancings too have grown, and credit quality has remained very high. Fannie Mae and Freddie Mac have been among those boosting volumes and introducing new programs to serve the multifamily market.

This section will review these market developments, interpret the performance of Fannie and Freddie within that market context, and discuss future prospects for the multifamily rental market, its financing, and the GSE role. The intention here is only to update the discussion from 2000. For general background information on the multifamily mortgage market and the GSEs, see the 2000 Rule and the HUD-sponsored research report, *Study of Multifamily Underwriting and the GSEs' Role in the Multifamily Market* (Abt Associates, 2001).

2. The Multifamily Rental Housing Market: 2000–2003

The definition of "good" market conditions in multifamily rental housing depends on one's perspective. Investors and lenders like low vacancies, steady rent increases, and rising property values. Developers like strong demand for new construction and favorable terms on construction financing. Consumers, in contrast, prefer low rents and a wide selection of available apartments.

The mid- to late-1990s were among the most successful of recent history, in that apartment market conditions were generally good for all of these interest groups. Investment returns were favorable, construction volumes were steady at sustainable levels, and many consumers had income gains in excess of their rent increases.

Market conditions for multifamily rental housing began to weaken toward the end of 2000. Early warnings came from the publicly traded apartment companies, some of which reported easing in demand growth in the first months of 2001, coinciding with a slowdown in job growth to its lowest level since 1992.

By 2003, rental units were experiencing record high vacancy rates and newly completed apartments faced record low absorption or ease-up rates. The rental sector vacancy rate averaged 9.8 percent in 2003, up 0.8 percent from 2002, and the highest annual vacancy rate I the more than 40-year history of the measure.[217]

Apartments—especially those serving the top end of the rental market—appear to have performed worse than other rental housing in the past four years, after several years of rent growth and occupancies surpassing the rental market averages. The multifamily (5+ units in structure) vacancy rate has increased more than the overall rental market vacancy rate in each of the years 2000, 2001, 2002, and 2003. For example, the Census Bureau's estimate of a 0.9 percentage point increase in vacancies for multi-family apartments in 2003 exceeds the overall rental vacancy rate of 0.6 percent.[218] Similarly, while rent growth has decelerated slightly for all rental housing according to the CPI, industry surveys of apartment rents show year-over-year declines in rents in many local markets.[219] In 2003, asking rents remained flat nationally, as multifamily completions declined 5 percent.[220]

a. Apartment Demand and Supply

The primary reason for the softening in the multifamily rental market has been a reduction in the growth of consumer demand for apartment housing. The general slowdown in economic activity meant fewer apartment customers, with less money, than if the economy were vigorously expanding. Persistent low interest rates have also enticed renters into the home purchase market as evidenced by the U.S. homeownership rate, which grew to 68.4 percent in 2003, further contributing to a weakness in rental demand.

The reduced demand is most evident in the national statistics on employment. Job growth began decelerating in late 2000 and throughout 2001, turning negative late that year. The largest year-over-year job loss of the economic downturn occurred in February 2002, and year-over-year losses have continued through October 2003.[221] Apartment demand seems particularly sensitive to labor market conditions, given the importance of rental housing to mobile individuals and families accepting new jobs or transfers. Reis, Inc., a real estate market research firm, estimates that the total number of occupied apartments (in properties with 40+ units) actually declined in both 2001 and 2002 in the large markets nationwide that are monitored by the company.[222] Job numbers showed some rebound in the subsequent period.

Households, not jobs, fill apartments, and for this reason household formations are a preferable indicator of demand for apartments as well as other types of housing. The Census Bureau estimates that the total number of renter households nationwide has been essentially unchanged at approximately 34.8 million since 1996. Yet during the late 1990s apartment demand was expanding, and apartments were apparently picking up market share from other rental housing. The past two or three years may have seen a reversal of that trend in share.

Long-term demographic trends are expected to be favorable for rental housing demand.[223] The maturing of the "Baby Boom Echo" generation will increase the number of persons under age 25 who will seek rental housing, immigration is expected to continue to fuel demand for rental housing, and minority populations, while increasing their homeownership rates, are growing and will contribute to higher absolute demand for rental housing. Thus demographic trends support an improvement in the long-run demand for rental demand, which is likely to include higher multifamily rental demand.

Supply growth has been maintained, even though the current reduced multifamily demand warrants less new construction. Total multifamily starts (2+ units) have been running approximately 325-to-350 thousand annually for the past six years, according to Census Bureau statistics, adding about 1 percent annually to the total multifamily stock. Most of these new units are built for rental use, with only about 20 percent in

[215] "Improving Credit Quality, Maturing Business Stoke Confidence in Subprime MBS Market," *Inside MBS & ABS*, published by Inside Mortgage Finance, February 21, 2003.

[216] *Ibid.*

[217] U.S. Department of HUD, Office of Policy Development and Research, *U.S. Housing Market Conditions: 4th Quarter 2003,* February 2004, p. 3.

[218] U.S. Department of HUD, Office of Policy Development and Research, *U.S. Housing Market Conditions: 4th Quarter 2003,* February 2004, p. 84.

[219] See, for example, Marcus & Millichap Research Services, *National Apartment Report,* January 2003.

[220] Marcus & Millichap Research Services, *National Apartment Report,* January 2004.

[221] U.S. Department of Labor, Bureau of Labor Statistics, "Bureau of Labor Statistics Data," Accessed July 31, 2004, *http://data.bls.gov/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000.*

[222] "Apartment Landlords Gather to Dreary Outlook for Sector," *Wall Street Journal,* January 15, 2003, Section B.

[223] Mortgage Bankers Association of America, "MBA News Link: Rental Market Demographics "Favorable," Report Says," January 2003.

recent years reported as being built as for-sale condominium units.

The reduced short-term demand has shown through in absorption speeds for new apartments. The percentage of newly completed unfurnished apartments rented within three months of completion fell from 72 percent during 2000 to 63 percent during 2001 and to 59 percent during 2002, the lowest level in the 33-year history of the data series, according to the Census Bureau. This percentage rose slightly to 60 percent in 2003.[224]

b. Performance by Market Segments

Some segments of the multifamily rental market have been more affected than others by the recent softening. As mentioned earlier, the top end of the apartment market seems especially hard hit, as measured by rising vacancies and reduced rent growth. This segment is particularly dependent on job growth and transfers for new customers, and is particularly vulnerable to losses of residents and prospective customers to home purchase. According to reports by apartment REITs and other investors, these top-end properties have not been getting the job-related in-movers, but have still been losing a lot of customers to home purchase. These properties generally have annual resident turnover rates of above 50 percent, and thus are particularly quickly influenced by changes in demand. Furthermore, this is the segment of the apartment market into which most of the new construction is built.

Performance has varied geographically as well. Some of the coastal markets, especially in Northern California, saw the double-digit rent increases of the late 1990s replaced by double-digit declines, before stabilizing more recently. ''Supply constrained markets'' had been preferred by apartment investors during the 1990s, but recent market performance has reminded investors and analysts that all markets have their day. For example, Houston posted the biggest year-over-year rent increase of any major apartment market in 2001, despite a long-run history of moderate rent growth and few barriers to new apartment construction. Rent changes in the 27 metro markets for which estimates are available from the CPI ranged from a low of −0.3 percent to a high of 6.7 percent in the first half of 2003 relative to a year earlier. And across the 75 metro areas for which rental vacancy rates (apartments plus other rentals combined) are available, rates for the year 2002 ranged from 2.4 percent to 15.4 percent, according to the Census Bureau. In a historical context, this variation is moderate, although up somewhat since the late 1990s.

Conditions in the ''affordable'' segment of the apartment market are harder to track than in the high-end segment because of lesser investor interest and analyst coverage. Data for the late 1990s analyzed by the National Housing Conference saw affordability problems continuing, although a study of apartment renters by the National Multi Housing Council saw some improvement in affordability during the strong economic growth of 1997–1999.[225] Other work noted that rent to income ratios for the lowest income quintile of renters rose during the late 1990s even as these ratios were stable or declining for other renters.[226] Harvard's *State of the Nation's Housing* report for 2002 highlighted the variability of the affordability problem from place to place.[227]

Little research is available on affordability trends since 1999. However, tabulations from the 2001 *American Housing Survey* indicate that income growth between 1999 and 2001 in the lowest quintile of renter households continued to lag that of higher income renters, and fell short of the average rent increases during this period. Together, these statistics suggest that affordability has deteriorated early this decade among at least this group of very low-income renters. Other work using the AHS found that the number of low-to moderate-income working families with severe rental cost burdens increased 24 percent between 1999 and 2001.[228]

The low-income housing tax credit (LIHTC) continues to finance much of the newly built multifamily rental housing that is affordable to households with moderate income. Restricted to households with incomes no greater than 60 percent of the local median, this program financed approximately 75,000 units in 2001, according to the National Council of State Housing Agencies, after running in the mid- to high-60 thousand range the previous three years. About 70 percent of these units are newly built, and the rest are renovations of existing units.

Expenditures for improvements to existing rental apartments have grown in recent years. In 2001 the total of $11.3 billion was nearly twice the figure of three years earlier, according to the Census Bureau, and more than a third as large as construction spending for newly built multifamily structures, including owner-occupied condos. Many of these improvements are to older properties in high-demand neighborhoods. Improvements to the physical structures have external benefits. But often the renovations are in connection with re-positionings that move the apartments into a higher rent range and bring changes in the demographic composition of the resident base.

In 2002, expenditures on total improvements to existing apartments declined to $9.8 billion, while new construction spending increased $2 billion. This shift further suggests a re-positioning to apartments with a higher rent range. Excluding units financed with tax credits or other subsidies, most of the multifamily rental construction in recent years has been targeted on the upper end of the market, often the only segment for which unsubsidized new construction is economically feasible. The median asking rent on new unfurnished apartments completed in 2001 was $877, up 11 percent over the previous two years. In 2002 median asking rent for these properties was $905. Of those units brought to market in 2002, 45 percent were at rents at or above $950.

3. Multifamily Financing Trends

In contrast to the softening observed in the demand/supply balance for multifamily, mortgage financing of these properties has been at a record pace in the past three years.

a. Lending Volume

Total multifamily mortgage debt outstanding increased 11 percent in 1999, 8.7 percent in 2000, 11.2 percent in 2001, 9.6 percent in 2002, and 11.2 percent in 2003 according to the Federal Reserve's flow of funds accounts. The dollar volume for 2003, $544.2 billion, is above those of any previous year. The pace seems to have slowed for 2004, with the first quarter indicating an annualized growth of 4.9 percent. Furthermore, a 2003 survey by the Mortgage Bankers Association of America show that of 48 member firms surveyed, representing all large mortgage banking firms an a cross section of smaller mortgage companies, multifamily origination volume increased 21.5 percent in 2003—from $41 billion in 2002 to $49.8 billion in 2003.

The apparent inconsistency between current market fundamentals and financing can be explained by low interest rates. The same financial forces that lowered the mortgage rates for home purchasers to record lows by 2002 also reduced the financing costs of multifamily properties. The ten year Treasury yield, a common benchmark for multifamily loan pricing, fell to a 45-year low of 3.3 percent in June 2003 from 6.3 percent as recently as the end of 1999.

Another feature boosting investor demand for apartment properties and the resulting demand for debt to finance those purchases has been the lack of attractive returns on many financial assets and other alternative investments. Despite the current weak performance of apartments, investors apparently are looking through to the long-run outlook for these assets, which is generally thought to be favorable, as indicated most recently by investor surveys fielded by the Urban Land Institute and by Lend Lease and PriceWaterhouseCoopers.[229]

The net change in mortgage debt outstanding is defined as loan originations less repayments and charge offs. As discussed in Appendix D, net change is a lower bound on originations. By all accounts, originations—for which no single source of estimates is available—are much higher than net change in most years. High levels of refinancings of existing multifamily mortgages in recent years has been a factor in originations exceeding the net change in debt outstanding.

[224] U.S. Department of HUD, Office of Policy Development and Research, *U.S. Housing Market Conditions: 4th Quarter 2003,* February 2004, p. 70.

[225] Center for Housing Policy/National Housing Conference, ''Housing America's Working Families: A Further Exploration,'' *New Century Housing,* Vol. 3, No. 1, March 2002; Mark Obrinsky and Jill Meron, ''Housing Affordability: The Apartment Universe,'' *National Multi Housing Council,* 2002.

[226] ''Housing Affordability in the United States: Trends, Interpretations, and Outlook,'' a report prepared for the Millennial Housing Commission by J. Goodman, November, 2001.

[227] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing,* 2002.

[228] Center for Housing Policy/National Housing Conference, ''America's Working Families and the Housing Landscape 1997–2001,'' *New Century Housing,* Vol. 3, No. 2, November 2002

[229] Urban Land Institute, *The ULI Forecast, 2002*; Lendlease and PriceWaterhouseCoopers, *Emerging Trends in Real Estate, 2003*.

Most mortgage lending is in the ''conventional'' market. Multifamily loan programs of the Federal Housing Administration accounted about $7 billion in new insured mortgages in fiscal year 2003—up from $6 billion in fiscal year 2002 and $5 billion in fiscal 2001. Despite the recent increase in FHA originations, and the likely continued strong performance for FHA multifamily programs in the foreseeable future, [230] FHA remains but a small portion of the total multifamily mortgage market. Outstanding FHA-insured multifamily mortgage debt was $55 billion at the end of the first quarter of 2003—only about 11 percent of all multifamily mortgage debt outstanding.

Multifamily lending has been spurred by new apartment construction, property sales, and refinancings. New multifamily construction was valued at $34.1 billion in 2003, according to the Census Bureau, up 21 percent from 2000.[231] The number of new multifamily units completed over this period actually declined 12 percent, and the increased expenditures reflect higher costs per unit. The increase in asking rents described earlier suggests higher property values and greater debt carrying capacity.

b. Property Sales and Refinancings

Sales of existing apartment properties tend to be procyclical. Increasing asset values bring buyers to the market and tempt sellers to realize their capital gains. In soft markets, in contrast, the bid-ask spread generally widens and the volume of sales declines, as sellers perceive current offers as beneath the property's long run value and buyers are reluctant to pay for past performance or the hope of future gains. Sales tend to increase mortgage debt, because the loan originated to finance the purchaser's acquisition is typically considerably larger than the mortgage retired by the seller.

No source of apartment property sales statistics matches the comprehensive national coverage of the single-family market provided by the National Association of Realtors' monthly estimates. But surveys by the National Multi Housing Council and other apartment industry reports indicate that transactions volume dipped during 2001 but since then have grown appreciably in both number of sales and aggregate dollar value.

Mortgage lending volumes have recently been boosted by shifts in property ownership. Publicly traded real estate investment trusts had been the big gainers during most of the 1990s, and by 1999 owned nearly 6 percent of all apartments nationwide and a considerably larger share of all big (100+ unit) properties. But beginning in 1999 capital market developments made private buyers more competitive. Since then the number of apartments owned by large REITs has declined about 5 percent, with diverse private interests apparently picking up market share.

Private investors are able to use more leverage—greater debt—in financing their transactions than the market permits the public REITs. As a result, the very low mortgage rates recently have given them an advantage in bidding on properties. In addition, equity funding costs of REITs rose as their stock prices flattened or moved down as part of the broader equity market correction.

Refinancings have, by all accounts, also been strong. Despite the lockout provisions and yield maintenance agreements that constrain early refinancings of many multifamily loans, lenders reported very strong refinancing activity in 2001 and continuing into 2002. Although refinancing volume data for the entire market are not available, the trends in refinance volume for FHA and the GSEs show very strong increases in refinance activity during 2002 and 2003. For example, FHA's Section 223(a)(7) program, which is limited to refinancing of FHA multifamily mortgages, experienced an increase in origination volume of 133 percent in Fiscal Year 2003 and 181 percent in Fiscal Year 2002. ($1.73 billion in FY 2003, $0.74 billion in FY 2002, and $0.26 billion in FY 2001). Similarly, the GSEs increased their combined volume of refinances by 83 percent from 1999–2000 to 2001–2002, from $17.6 billion to $32.1 billion. Refinancings, especially when motivated by a desire to lower interest expense rather than to extract equity, do not add as much to debt outstanding as do purchase loans, which often are much larger than the seller's existing mortgage that is repaid at the time of sale. Nonetheless, refinancings represent a significant part of all multifamily mortgage lending.

c. Sources of Financing and Credit Quality

The sources of funding of multifamily mortgages shifted somewhat in the past few years, judging from the Flow of Funds accounts. As shown in Table A.4, four categories of lenders have dominated multifamily mortgage lending since the mid-1990s. Of those four, commercial banks have played a lesser, although still substantial, role in recent years, providing 20 percent of the $86 billion in net additional funding of multifamily mortgages during 2000 and 2001. The portfolio holdings of the GSEs, by contrast, have been much more important than during the last half of the 1990s. Mortgage backed securities, both from the GSEs and especially from other issuers, accounted for proportionally less of the growth in 2000–01 than in 1995–99, but between them still accounted for nearly half of all the net credit extensions. Some slight broadening of the base of multifamily lending in the past two years, as these four lender groups accounted for only 85 percent of the net credit extended in 2000 and 2001, compared to all of it in the previous five-year period.

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[230] Merrill Lynch, *A New Look at FHA Prepayments and Defaults*, September 2002.

[231] Eight percent inflation adjusted.

Table A.4

Providers of Net Additions to Multifamily Mortgage Debt Outstanding

(Percent distribution)

	2000-2001	1995-1999
Commercial Banks	20 %	27 %
Fannie Mae/ Freddie Mac		
Portfolio	15	2
MBS	18	25
Private MBS	17	32
All Others	30	14
Total	100 %	100 %
Memo: Aggregate Net Addition to Debt ($ billions)	85.5	93.9

Sources: Federal Reserve Flow of Funds Accounts, OFHEO 2001 Annual Report.

The market values of apartment properties have generally held up well, although the most recent indicators suggest some flattening. Properties in the portfolios of pension funds continued to appreciate into the second half of 2002, according to the National Council of Real Estate Investment Fiduciaries, although at a reduced annual rate of less than 2 percent. And the sales price per square foot of "Class A" properties monitored by Global Real Analytics rose until turning down in early 2002, posting a 1.6 percent year over year decline in the second quarter.

The continuing value of collateral has helped keep loan quality high on multifamily mortgages. Delinquency rates from all major reporters are at or near record lows, and well below the rates reported for single-family mortgages and commercial properties. At commercial banks, the FDIC reports a 0.38 non-current loan percentage in the second quarter of 2002. In life insurance company portfolios the only 0.05 percent of residential mortgages were overdue at the end of 2002, and as of the third quarter of 2002 the GSEs were both reporting similarly miniscule delinquency rates of below 0.1 percent; all of these rates are below those of a year earlier.

Multifamily lenders have remained cautious in their underwriting and, together with their regulators; have avoided repeating the mistakes of the 1980s. Many of the senior loan officers surveyed quarterly by the Federal Reserve have reported tightening their terms on commercial mortgages, and that shift likely has occurred in their multifamily lending as well. Perhaps the best indicator of discipline in multifamily lending is the fact that, despite the strong apartment demand during the last half of the 1990s, construction never rose above its long-run sustainable level, unlike the rampant overbuilding that plagued the industry in the mid- and late-1980s.

4. Recent GSE Involvement in Multifamily Finance

As the multifamily mortgage market has expanded since 1999, Fannie Mae and Freddie Mac have increased their lending, picked up market share, introduced new programs, and enhanced others.

Beginning with their whole loans, the GSEs added 34 percent to their combined holdings of multifamily loans in 2001, and another 26 percent in 2002 (see Table A.6 below). The growth in multifamily MBS volume was nearly as dramatic, increasing 26 percent in 2001 and another 14 percent in 2002. The gains resulted in the GSEs increasing their share (whole loans and securities combined) of all multifamily debt outstanding to 22.8 percent by the third quarter of 2003, up from 19 percent at year-end 2001, 15 percent at year-end 1999 and 11 percent at the end of 1995. By this combined measure of portfolio holdings and MBS outstanding, at year-end 2002 Fannie Mae had nearly twice ($65 billion versus $37 billion) the multifamily business of Freddie Mac, although Freddie was growing its multifamily business more rapidly (67 percent increase between 2000 and 2002, compared to 46 percent increase for Fannie Mae). In 2003, Freddie Mac's multifamily business activities totaled $21.587 billion ($14.894 billion of mortgage purchases and $6.693 billion in investment activities). These activities financed rental housing for 549,083 families. Nearly 92 percent of these units were affordable to low- and moderate-income renters. Since 1993, Freddie Mac has purchased $75.5 billion in multifamily mortgages, financing housing for more than 2.2 million families.[232]

Measures that focus on new multifamily activity, specifically gross mortgage purchase volumes and new security issuance, vary across recent years and between the GSEs. For the GSEs combined, these measures of current business activity show sharp gains of over 70 percent in 2001, following small decreases in activity in 2000. In 2002, the GSEs combined posted small declines for both measures. Measures of multifamily gross mortgage purchases and new security

[232] Freddie Mac Public Comment Letter on HUD's Proposed Goals, July 2004, p.3.

issuance diverged for the two GSEs in 2002. Fannie Mae experienced declines in these balance sheet and new business indicators in 2002 while Freddie Mac experienced gains, particularly in new security issuance. As discussed earlier, the credit quality of GSE multifamily loans has remained very high even with the large gains in loan volume.

Despite the substantial pickup in GSE multifamily activity, the position of these companies in the multifamily mortgage market remains well below their dominance in single-family mortgage finance. At the end of 2002, the GSEs' market share of single family debt outstanding was 44 percent, twice the share of multifamily debt held or securitized by these two companies, according to Federal Reserve statistics. Furthermore, the multifamily share of all housing units financed by the GSEs combined has declined from its 1997 level (Table A.5), although the annual statistics are heavily influenced by the volume of refinancings in the single-family market, which spiked in 1998 and again in 2001 and 2002 in response to the big decline in mortgage rates in those years. Because of lock-out agreements and other loan covenants, multifamily loans are not as prone to rate-induced refinancings as are single-family mortgages.

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Table A.5

Multifamily Share of All Housing Units Financed

	Units Financed								
	Fannie Mae			Freddie Mac			GSEs Combined		
Year	Multifamily	Total	Multifamily Share	Multifamily	Total	Multifamily Share	Multifamily	Total	Multifamily Share
1997	253,065	1,888,547	13.4%	99,470	1,213,126	8.2%	352,535	3,101,673	11.4%
1998	394,345	3,707,839	10.6%	221,319	2,718,565	8.1%	615,664	6,426,404	9.6%
1999	294,186	3,109,885	9.5%	191,492	2,328,800	8.2%	485,678	5,438,685	8.9%
2000	289,891	2,293,397	12.6%	163,580	1,677,295	9.8%	453,471	3,970,692	11.4%
2001	503,909	4,893,900	10.3%	315,868	3,381,036	9.3%	819,777	8,274,936	9.9%
2002	461,397	6,362,315	7.3%	333,038	4,552,277	7.3%	794,435	10,914,592	7.3%
2003	809,703	10,093,826	8.0%	412,672	5,752,541	7.2%	1,222,375	15,846,367	7.7%

Source: GSE Annual Housing Activity Reports, Table 1; figures for 2001 are adjusted for REMIC weights and participations.

a. Contrasting Business Models

While both Fannie Mae and Freddie Mac have significantly increased their multifamily activities in recent years, they have pursued distinct business models in achieving that growth. As shown in Table A.6, most of Fannie Mae's multifamily growth has come in MBS products, whereas Freddie Mac has relied more on loans purchased and held in its portfolio. At the end of 2002, Fannie Mae had almost four dollars of outstanding MBSs for every dollar of portfolio holdings. Freddie

Mac, on the other hand, more than three times as much volume in portfolio as it had in MBS outstanding.

Table A.6

GSE Multifamily Mortgage Activity, 1998-2002

($ millions)

	1998	1999	2000	2001	2002
Fannie Mae					
MF Whole Loans in Portfolio	8,185	7,911	8,361	10,538	13,571
% Change From Previous Year		-3.3%	5.7%	26.0%	28.8%
MF MBS Outstanding	28,535	32,221	35,987	44,909	51,111
% Change From Previous Year		12.9%	11.7%	24.8%	13.8%
MF Purchases (Cash + Securitizations)	11,428	10,012	10,377	19,131	16,611
% Change From Previous Year		-12.4%	3.6%	84.4%	-13.2%
MF MBS Issuance	11,028	8,497	7,596	13,801	12,338
% Change From Previous Year		-23.0%	-10.6%	81.7%	-10.6%
Freddie Mac					
MF Whole Loans in Portfolio	7,978	12,355	16,369	22,483	28,036
% Change From Previous Year		54.9%	32.5%	37.4%	24.7%
MF MBS Outstanding	N/A	4,462	5,708	7,476	8,780
% Change From Previous Year			27.9%	31.0%	17.4%
MF Purchases (Cash + Securitizations)	3,910	7,181	6,030	9,509	10,656
% Change From Previous Year		83.7%	-16.0%	57.7%	12.1%
MF MBS Issuance	937	2,045	1,786	2,356	3,596
% Change From Previous Year		118.2%	-12.7%	31.9%	52.6%
Combined					
MF Whole Loans in Portfolio	16,163	20,266	24,730	33,021	41,607
% Change From Previous Year		25.4%	22.0%	33.5%	26.0%
MF MBS Outstanding	N/A	36,683	41,695	52,385	59,891
% Change From Previous Year			13.7%	25.6%	14.3%
MF Purchases (Cash + Securitizations)	15,338	17,193	16,407	28,640	27,267
% Change From Previous Year		12.1%	-4.6%	74.6%	-4.8%
MF MBS Issuance	11,965	10,542	9,382	16,157	15,934
% Change From Previous Year		-11.9%	-11.0%	72.2%	-1.4%

Source: Calculated from tables in OFHEO 2001 Annual Report.

The differing emphasis on portfolio holdings and securities issuance is related to the GSEs' contrasting approaches to credit underwriting.[233] Fannie Mae has long had risk-sharing arrangements with its multifamily loan originators, and currently has over 25 Delegated Underwriters and Servicers who are authorized to originate loans meeting Fannie Mae's requirements for sale to the GSE without prior approval of individual transactions. These ''DUS'' lenders retain part of the credit risk on the loans sold to Fannie.

Freddie Mac has taken a different approach to credit underwriting. In the wake of large credit losses on its multifamily business in the late 1980s and 1990, Freddie Mac essentially withdrew from the market. When it re-entered in late 1993, the company elected to retain all underwriting in-house and not delegate this function to the loan originators participating in Freddie Mac's Program Plus network. Because Freddie Mac assumes the entire credit risk on loans it purchases, some commercial banks and other financial institutions desiring to remove multifamily loans and all related liabilities from their books find Freddie Mac's program preferable.

[233] ''No Mistaking GSEs for Twins in Multifamily,'' *American Banker,* October 2, 2002.

b. Affordable Multifamily Lending

Because most of the GSEs' multifamily lending is on properties affordable to households with low-or moderate incomes, financing of affordable multifamily housing by the GSEs has increased almost as much as their total multifamily lending. Approximately 87 percent of Fannie Mae's multifamily lending volume in 2003 qualified as affordable to low-or moderate income households, according to Fannie Mae's annual Housing Activity Report, as did 92 percent of Freddie Mac's multifamily units financed. For the entire multifamily rental market, HUD estimates that 90 percent of all housing units qualify as affordable to families at or below 100 percent of the area median income, the standard upon which the low- and moderate-income housing goal is defined.

Owing to this high propensity to qualify as affordable lending, financing of multifamily rental housing is especially important for the GSEs attainment of their affordable housing goals. Less than 8 percent of the units financed by the GSEs in 2002 were multifamily rentals, as described above. Yet 15 percent of the units qualifying as low- and moderate-income purchases were multifamily, according to Table 1 of the GSEs' activity reports for 2002.

The GSEs increased the volume of their affordable multifamily lending dramatically in 2001, the first year of the new, higher affordable housing goals set for the GSEs. As measured by number of units financed, the total affordable lending (shown in the ''low-mod total'' rows of Table A.7) more than doubled from a year earlier, especially after application of the upward adjustment factor authorized for Freddie Mac in the 2000 Rule. In 2003 the GSEs maintained a high volume of affordable multifamily lending.[234]

[234] This change was a percentage decrease but a volume increase.

Table A.7

Multifamily Units Financed

	1998	1999	2000	2001	2002	2003	Source
Fannie Mae							
Total	393,397	294,091	289,509	503,909	461,397	809,703	1
Percent Change		-25%	-2%	74%	-8%	75%	
Small	64,753	12,351	7,196	37,449	77,485	231,458	2
Large	328,644	281,740	282,312	466,460	383,912	578,245	2
Low-Mod Total	334,042	274,026	266,410	463,655	416,905	662,808	3
Percent Change		-18%	-3%	74%	-10%	59%	
Small	52,508	10,017	6,244	32,732	67,892	175,423	3
Large	281,534	264,009	260,166	430,923	349,012	487,385	3
Underserved Areas Total	170,488	110,532	107,603	228,960	203,491	360,959	3
Percent Change		-35%	-3%	113%	-11%	77%	
Small	43,133	5,879	4,042	23,794	50,204	115,402	3
Large	127,356	104,653	103,561	205,166	153,287	245,557	3
Special Affordable Total	180,726	164,068	147,641	267,513	241,359	351,038	3
Percent Change		-9%	-10%	81%	-10%	45%	
Small	33,256	5,832	4,450	19,771	39,548	89,652	3
Large	147,470	158,236	143,191	247,742	201,811	261,386	3
Freddie Mac							
Total	221,319	191,492	163,580	315,370	310,614	593,959	1
Percent Change		-13%	-15%	93%	-2%	78%	
Small	10,244	4,068	2,996	50,492	22,262	181,287	2
Large	211,075	187,424	160,584	264,878	288,352	412,672	2
Low-Mod Total	211,760	172,417	151,166	294,875	276,253	503,871	3
Percent Change		-19%	-12%	95%	-6%	69%	
Small	9,421	3,322	2,621	48,062	19,348	155,185	3
Large	202,339	169,095	148,545	246,813	256,905	348,686	3
Underserved Areas Total	96,431	69,175	58,758	145,068	131,813	366,620	3
Percent Change		-28%	-15%	147%	-9%	138%	
Small	5,881	2,059	1,833	43,252	19,553	158,342	3
Large	90,550	69,175	56,924	101,817	112,260	208,278	3
Special Affordable Total	120,776	82,982	79,375	168,753	144,292	295,964	3
Percent Change		-31%	-4%	113%	-14%	86%	
Small	5,785	1,526	1,636	36,600	13,252	95,367	3
Large	114,991	81,455	77,739	132,153	131,040	200,597	3

Sources: 1. Tables 15a, 15b of Summary Tables for 1993-2000 on HUD User web site. For 2001-2003, Annual Housing Activity Report Table 1.

2. For 1998-99, Table 4 of Summary Tables for 1993-2000 on HUD User web site. For 2001-2003, Annual Housing Activity Report Table 1.

3. For 1998-99, Table 4 of Summary Tables for 1993-2000 on HUD User web site. Totals for 1998-99 calculated as sum of small and large. For 2000-2001, Annual Housing Activity Report Table 1.

Totals for 2001-2003 are the "adjusted" totals from Annual Housing Activity Report Table 1 exclusive of adjustments for bonuses and Freddie Mac's Temporary Adjustment Factor.

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The figures in Table A.7 are exclusive of the ''Temporary Adjustment Factor (TAF)'' granted to Freddie Mac as part of the 2000 Rule. The TAF was a response to Freddie Mac's limited opportunities for refinancing business because of its minimal involvement in the multifamily market in the early and mid-1990s.[235] The TAF, which expired at the end of 2003, provided a 20 percent upward adjustment to multifamily units in properties with 50 or more units, for purposes of the affordable housing goals.

Multifamily financing made major contributions not only to the GSEs' attainment of the overall goal for affordable lending in 2002, but also to the ''underserved areas'' goal and ''special affordable'' goal. As shown in Table A.7, the 2001 increases in lending in each of these categories were substantial at both Fannie Mae and Freddie Mac, again leveling off for both in 2002. The GSEs also met the special multifamily affordable subgoal set in the 2000 Rule in both 2001 and 2002.

c. Multifamily Initiatives of the GSEs

Fannie Mae and Freddie Mac have taken a number of steps since 2000 to expand their multifamily lending and to respond specifically to the goals established in the 2000 Rule. These initiatives are summarized in the annual activity reports filed by the GSEs.[236]

One focus of the 2000 Rule was on lending to small (5-to-50 units) multifamily properties, which the Rule identified as an underserved market. HUD-sponsored research has found that the supply of mortgage credit to small properties was impeded by the substantial fixed costs of multifamily loan originations, by owners' insufficient documentation of property income and expense, and by the limited opportunities for fees for underwriting and servicing small loans.[237] As a result, many multifamily lenders focus on larger properties, which were found to have more loan products available to them and to pay lower interest rates than did small properties.

In an attempt to promote the supply of credit to small properties, the 2000 Rule provided incentives for the GSEs to step up their involvement in this segment of the multifamily mortgage market. The incentives likely contributed to the huge increases in small property lending posted by both Fannie Mae and Freddie Mac in 2001 and continuing into 2002 (Table A.7). The combined total of these units financed in 2001 and 2002 was almost 8 times those financed in the previous two years. This lifted the percentage of all GSE multifamily lending that was on small properties to their highest levels ever.

During 2003, multifamily business activity at Fannie Mae topped $33 billion which financed over 809,703 multifamily units. Of this total, over 87% were affordable to families at or below the median income of their communities.[238] Freddie Mac multifamily business activities totaled a record $21.587 billion which financed rental housing for 549,083 families. Nearly 92 percent of these apartment units were affordable to low- and moderate income renters.[239]

Programs introduced or enhanced by the GSEs in the past two years have contributed to these striking numerical results. Delegated Underwriting and Servicing (DUS) is Fannie Mae's principle product line for purchasing individual multifamily loans. This product line is offered through 26 lenders with expertise in financing multifamily properties. In 2003, 91% of the DUS loan activity served affordable housing needs, 42% of DUS loans in underserved markets, and 52% addressed ''special affordable'' needs.[240] Believing that small multifamily properties are a vital part of the country's affordable housing stock, Fannie Mae has focused efforts on providing financing for these projects through the development of the MFlex Loan Product, the 3MaxExpress Streamlined Mortgage Loan Product and the Affordable Alliances Loan Product. The MFlex Loan Product was established in 2000 to target lending partners that serve small property borrowers and increase Fannie Mae's participation in the 5–50 unit property market. By 2003, Fannie Mae had seven MFlex lending partners and had purchased $1.6 billion of these loans. Fannie Mae markets its specialized 3MaxExpress Streamlined Mortgage Loan Product line for loans worth less than or equal to $3 million. In 2003, Fannie Mae provided $1 billion in financing, which assisted over 34,000 families living in small multifamily properties. The Affordable Alliances Loan Product is responsible for debt investments in rental housing targeted to persons of low- and moderate-income and to rental markets that are underserved. During 2003, these financing initiatives provided affordable housing for 3,850 families. [241] Fannie Mae additionally has federal Low-Income Housing Tax Credit (LIHTC) programs and special financing projects for special use properties such as Seniors Housing. In 2003, Fannie Mae committed over $1.6 billion in LIHTC equity properties to help make affordable rental housing possible for over 30,000 families.[242]

During 2003, Freddie Mac used innovative financing structures combined with prudent, flexible multifamily lending practices, which enabled them to reach a record level of multifamily mortgage purchases.[243] The GSEs face strong competition in this market from small banks and other depository institutions that prefer to hold these loans in their own portfolios.[244]

In 2003, Freddie Mac continued to test initiatives through pilots, and implement enhancements to existing multifamily mortgage products which cover a broad array of eligible mortgage products. Freddie Mac's tax-exempt bond credit enhancements with synthetic fixed-rate financing continued to be popular. Freddie Mac's innovations to certain cash products including various combinations of fixed-rate, adjustable-rate and interest-only mortgages have been adopted by others in the industry. For example, the Fixed-to-Float execution provides borrowers with a reduced fixed interest rate and a one-year extension of the mortgage term at a floating rate. In 2003, borrowers used Fixed-to-Float option for $4.0 billion in mortgages.[245]

In 2003, Freddie Mac purchased $6.6 billion in mortgages to finance more than 181,000 apartment units in 5-to 50-unit properties. Freddie Mac committed to invest $958 million to Low Income Housing Tax Credits (LIHTC). Altogether, the LIHTC investments made by Freddie Mac are approaching the $3.6 billion mark and have constructed or rehabbed more than 216,000 rental units for very-low and low income families in close to 3,000 projects. In 2003, Freddie purchased $412 million in newly issued multifamily mortgage revenue bonds. These bonds, issued by state, county or city government agencies, finance the acquisition and rehabilitation of nonprofit borrowers or property owners who agree to keep rents at affordable levels. These multifamily bond purchases will finance 6,100 estimated units of affordable housing with an estimate that 58 percent of those units will be affordable to very low income families. In 2003, Freddie issued a record $7.7 billion of securities backed by multifamily mortgages through negotiated transactions. More than 85 percent of these securities financed mortgages for affordable housing.[246]

The 2000 Rule discussed other ways in which the GSEs might help promote financing of affordable multifamily housing. Two of those were lending for property rehabilitation and leadership in establishing standards for affordable multifamily lending. Many affordable properties are old and in need of capital improvements if they are to remain in the housing stock. Rehabilitation lending is a specialized field, and one in which the GSEs for a variety of reasons have not been major players. Less than 1 percent of all GSE multifamily lending in 2002 was for property rehabilitation. In 2002, Fannie Mae hosted its first ever Preservation Advisory Meeting with leaders in the housing and real estate finance industry to identify best practices and formulate real

[235] For background information on the Freddie Mac TAF, see pages 65054 and 65067–65068 of the 2000 Rule.

[236] *Fannie Mae's 2002 Annual Housing Activities Report,* pages 24–27; *Freddie Mac's Annual Housing Activities Report for 2002,* pages 41–47.

[237] Abt Associates Inc., *An Assessment of the Availability and Cost of Financing for Small Multifamily Properties,* a report prepared for the U.S. Department of Housing and Urban Development, Office of Policy Development and Research, August 2001.

[238] Fannie Mae, *2003 Annual Housing Activities Report,* March 15, 2004, p. 26.

[239] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 44.

[240] Fannie Mae, *2003 Annual Housing Activities Report,* March 15, 2004, p. 27.

[241] Fannie Mae, *2003 Annual Housing Activities Report,* March 15, 2004, p. 28.

[242] Fannie Mae, *2003 Annual Housing Activities Report,* March 15, 2004, p. 29.

[243] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 47.

[244] ''Fannie Courting Multifamily Sellers; Small Banks Balking,'' *American Banker,* January 13, 2003.

[245] Freddie Mac, *Opening Doors for America's Families:* Freddie Mac's Annual Housing Activities Repoert for 2003, March 15, 2004, p. 47 & 49.

[246] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003*, March 15, 2004, p. 50–52.

world solutions to this critical policy issue.[247]

Setting standards for affordable multifamily lending was identified in the 2000 Rule as another area where the GSEs could provide greater leadership. It was also noted, based on HUD-sponsored research underway at that time,[248] that market participants believe the GSEs to be conservative in their approaches to affordable property lending and underwriting. Actions described in the GSEs' annual activity reports for 2001, 2002 and 2003 indicate attempts by the GSEs to promote market standards that will reduce the transactions costs of multifamily lending while also providing programs that have the flexibility needed to deal with unique circumstances.

5. Future Prospects

The outlook for the multifamily rental housing market is marked by near-term risks and longer-run optimism, according to most observers. The prospects for the next few quarters are dominated by the macroeconomy. In particular, job growth, with its implications for formations of households, will be a key for the resumption of growth in apartment demand. Many forecasters would ascribe to the Federal Reserve's forecast of a slight increase in GDP growth to 4.3 percent in 2004 [249], while also agreeing with the Fed's warning that ''An unusual degree of uncertainty attends the economic outlook at present, in large measure, but not exclusively, because of potential geopolitical developments.'' [250]

When consumer demand does pick up, recovery should be reasonably fast. While the recent production levels have outpaced demand, they have been near the middle of the long run historical range and very close to the average of the last half of the 1990s. Judging from the firm tone to rents and vacancies during that period, total multifamily completions production of 275,000 to 350,000 units is a sustainable level of annual production—that is, the level consistent with long run demographic trends and replacement of units lost from the stock.

Because new construction has remained moderate, there is no massive overhang of product that will need to be absorbed. With increased demand, vacancies should fall and rents firm reasonably promptly. A key assumption behind this forecast for vacancies and rents is that new apartment construction will not rise appreciably from its current level.

Recovery in the apartment market may also, perversely, be promoted by the recent unprecedented strength of the single-family market. Typically, economic recoveries bring strong growth in single-family housing demand, some of that coming from apartment renters seeking more space. With single-family activity already near record highs, boosted by historically low mortgage interests rates and despite the recently soft economy, it is uncertain how much higher single-family demand—and the accompanying losses of apartment customers to homeownership—can go.

A stronger economy will put the multifamily rental market back onto a long-run path that appears to promise sustained, moderate growth. As discussed in the 2000 Rule, the demographic outlook is favorable for apartment demand. Even if the homeownership rate increases further and the total number of renter households grows only slowly, as described in the discussion of the single-family housing market earlier in this Rule, apartment demand can be expected to increase more rapidly than that for other rental housing, owing to the likely changes in age composition and reductions in average household size. One estimate projects the annual growth in apartment households to be one percent.[251]

a. The Outlook for Multifamily Housing Supply

Regarding supply, one of the secrets of the success of the multifamily sector during the 1990s was that production never rose above its long-run sustainable level. The discipline of developers, investors, and their lenders that brought that result needs to be continued if the apartment market is to maintain stability.

Multifamily housing may benefit in the future from more favorable public attitudes and local land use regulation. Higher density housing is a potentially powerful tool for preserving open space, reducing sprawl, and promoting transportation alternatives to the automobile. The recently heightened attention to these issues may increase the acceptance of multifamily rental construction to both potential customers and their prospective neighbors.

Provision of affordable housing will continue to challenge suppliers of multifamily rental housing and policy makers at all levels of governments. Low incomes combined with high housing costs define a difficult situation for millions of renter households. Housing cost reductions are constrained by high land prices and construction costs in many markets. Government action—through land use regulation, building codes, and occupancy standards—are major contributors to those high costs, as is widely recognized by market participants, including the leaders of the GSEs.[252] Reflecting the preferences of the electorate, these regulated constraints are unlikely to change until voter attitudes change.

b. The Future Role of the GSEs

Regarding the mortgage financing of multifamily rental apartments, it is hard to anticipate events that might disrupt the flow or alter the sources of mortgage credit to apartments. In the past, certain events have triggered such changes—notably the savings and loan debacle of the 1980s and Freddie Mac's withdrawal from the market following large losses in the early 1990s—but these are, by definition, surprises. The current structure and performance of the multifamily mortgage market provide some comfort that the risks are slight. The lender base is not overly dependent on any one institution or lender type for either loan originations or funding. Lending discipline appears to have been maintained, given the low mortgage delinquency rates even during the weak economy of the past two years. The near term outlook of most market participants is for ample supply of mortgage financing at historically low interest rates.[253] Yet complacency would be a mistake.

Responding to both market incentives and their public charters, Fannie Mae and Freddie Mac can be expected to build on their recent records of increased multifamily lending and continue to be leaders in financing volumes, in program innovations, and in standards setting. Certainly there is room for expansion of the GSEs' share of the multifamily mortgage market, which, as mentioned earlier, is by the measure of dollar volume outstanding currently only about half the market share enjoyed by the GSEs in single-family lending. And from the perspective of units financed, the statistics from Table A.5 combined with data from the 2001 American Housing Survey indicate that, while the GSEs financed 7.2 percent of all the nation's year-round housing units that year, the percentage of multifamily rental units (that is renter-occupied units and vacant rental units in structures with at least five units) was only 5.7 percent.

The sharp gains since 2000 in small property lending by Fannie Mae and Freddie Mac demonstrate that it is feasible for this important segment of the affordable housing market to be served by the GSEs. Building on the expertise and market contacts gained in the past three years, the GSEs should be able to make even greater in-roads in small property lending, although the challenges noted earlier will continue.

The GSEs' size and market position between loan originators and mortgage investors makes them the logical institutions to identify and promote needed innovations and to establish standards that will improve market efficiency. As their presence in the multifamily market continues to grow, the GSEs will have both the knowledge and the ''clout'' to push simultaneously for market standardization and for programmatic flexibility to meet special needs and circumstances, with the ultimate goal of increasing the availability and reducing the

[247] Fannie Mae, *2002 Annual Housing Activities Report*, 2003, p. 27.

[248] Abt Associates, ''Study of Multifamily Underwriting and the GSEs'' Role in the Multifamily Market,'' Final Report to the U.S. Department of Housing and Urban Development, Office of Policy Development and Research, August 2001.

[249] Federal Reserve, Survey of Professional Forecasters, November 2003.

[250] Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*, February 11, 2003, page 4.

[251] Jack Goodman, ''The Changing Demography of Multifamily Rental Housing,'' *Housing Policy Debate*, Winter 1999.

[252] Remarks by Franklin D. Raines, Chairman and CEO, Fannie Mae, to the Executive Committee of the National Association of Home Builders, January 18, 2003. See also Edward Glaeser and Joseph Gyourko, ''The Impact of Zoning on Housing Affordability,'' Working Paper 8835, National Bureau of Economic Research, March 2002.

[253] ''Capital Markets Outlook 2003,'' *Apartment Finance Today*, Vol. 7, No. 1 (January/February 2003).

cost of financing for affordable and other multifamily rental properties.

E. Factor 3: Performance and Effort of the GSEs Toward Achieving the Low- and Moderate-Income Housing Goal in Previous Years

This section first discusses each GSE's performance under the Low- and Moderate-Income Housing Goal over the 1996–2003 period.[254] The data presented are ''official results—*i.e.,* they are based on HUD's analysis of the loan-level data submitted to the Department by the GSEs and the counting provisions contained in HUD's regulations in 24 CFR part 81, subpart B. As explained below, in some cases these ''official results'' differ from goal performance reported by the GSEs in the Annual Housing Activities Reports (AHARs) that they submit to the Department.

The main finding of this section concerning the overall housing goals is that both Fannie Mae and Freddie Mac surpassed the Department's Low- and Moderate-Income Housing Goals for each of the eight years during this period. Specifically:

- The goal was set at 40 percent for 1996; Fannie Mae's performance was 45.6 percent and Freddie Mac's performance was 41.1 percent.
- The goal was set at 42 percent for 1997–2000. Fannie Mae's performance was 45.7 percent in 1997, 44.1 percent in 1998, 45.9 percent in 1999, and 49.5 percent in 2000; and Freddie Mac's performance was 42.6 percent in 1997, 42.9 percent in 1998, 46.1 percent in 1999, and 49.9 percent in 2000.
- In the October 2000 rule, the low- and moderate-income goal was set at 50 percent for 2001–03. As of January 1, 2001, several changes in counting provisions took effect for the low- and moderate-income goal, as follows: ''bonus points'' (double credit) for purchases of goal-qualifying mortgages on small (5–50 unit) multifamily properties and, above a threshold level, mortgages on 2–4 unit owner-occupied properties; a ''temporary adjustment factor'' (1.20 units credit, subsequently increased by Congress to 1.35 units credit) for Freddie Mac's purchases of goal-qualifying mortgages on large (more than 50 units) multifamily properties; changes in the treatment of missing data; a procedure for the use of imputed or proxy rents for determining goal credit for multifamily mortgages; and eligibility of purchases of certain qualifying government-backed loans to receive goal credit. These changes are explained below. Fannie Mae's low-mod goal performance was 51.5 percent in 2001, 51.8 percent in 2002, and 52.3 percent in 2003; Freddie Mac's performance was 53.2 percent in 2001, 50.5 percent in 2002, and 51.2 percent in 2003, thus both GSEs surpassed this higher goal in all three years. This section discusses the October 2000 counting rule changes in detail below, and provides data on what goal performance would have been in 2001–03 without these changes.[255]

After the discussion of the overall housing goals in Sections E.1 to E.5, Sections E.6 to E.12 examine the role of the GSEs in funding home purchase loans for lower-income borrowers and for first-time homebuyers. A summary of the main findings from that analysis is given in Section E.6. Section E.13 then summarizes some recent studies on the GSEs' market role and section E.14 discusses the GSEs' role in the financing of single-family rental properties.

1. Performance on the Low- and Moderate-Income Housing Goal in 1996–2003

HUD's December 1995 rule specified that in 1996 at least 40 percent of the number of units financed by each of the GSEs that were eligible to count toward the Low- and Moderate-Income Goal should qualify as low- or moderate-income, and at least 42 percent of such units should qualify in 1997–2000. HUD's October 2000 rule made various changes in the goal counting rules, as discussed below, and increased the Low- and Moderate-Income Goal to 50 percent for 2001–03.

Table A.8 shows low-mod goal performance over the 1996–2003 period, based on HUD's analysis. The table shows that Fannie Mae surpassed the goals by 5.6 percentage points and 3.7 percentage points in 1996 and 1997, respectively, while Freddie Mac surpassed the goals by narrower margins, 1.1 and 0.6 percentage points. During the heavy refinance year of 1998, Fannie Mae's performance fell by 1.6 percentage points, while Freddie Mac's performance rose slightly, by 0.3 percentage point. Freddie Mac showed a gain in performance to 46.1 percent in 1999, exceeding its previous high by 3.2 percentage points. Fannie Mae's performance in 1999 was 45.9 percent, which, for the first time, slightly lagged Freddie Mac's performance in that year.

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[254] Performance for the 1993–95 period was discussed in the October 2000 rule.

[255] To separate out the effects of changes in counting rules that took effect in 2001, this section also compares performance in 2001 to estimated performance in 2000 if the 2001 counting rules had been in effect in that year.

Table A.8

GSEs' Performance on the Low- and Moderate-Income Housing Goal, 1996-2003

	1996	1997	1998	1999	2000	2001*	2002*	2003*
Low-and Moderate-Income Goal	40%	42%	42%	42%	42%	50%	50%	50%
Fannie Mae:								
Units Eligible to Count Toward Goal	1,831,690	1,710,530	3,468,428	2,925,347	2,130,686	4,541,456	5,848,788	9,369,160
Low- and Moderate-Income Units	834,393	782,265	1,530,308	1,343,396	1,054,349	2,340,179	3,028,959	4,901,314
Percent Low- and Moderate-Income	45.6%	45.7%	44.1%	45.9%	49.5%	51.5%	51.8%	52.3%
Freddie Mac:								
Units Eligible to Count Toward Goal	1,293,424	1,173,915	2,654,850	2,224,849	1,578,236	3,238,783	4,242,047	5,456,414
Low- and Moderate-Income Units	532,219	499,590	1,137,660	1,024,660	788,324	1,723,699	2,140,130	2,793,670
Percent Low- and Moderate-Income	41.1%	42.6%	42.9%	46.1%	49.9%	53.2%	50.5%	51.2%

* Performance in 2001-2003 not directly comparable with performance in 1996-2000 due to changes in goal counting rules, as discussed in text, and shown in Table A.9.
Freddie Mac's goal performance in 2002 has been revised due to the double-counting of loans in 2001 and 2002, as discussed in the preamble to this Final Rule.

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Both GSEs exhibited sharp gains in goal performance in 2000—Fannie Mae's performance increased by 3.6 percentage points, to a record level of 49.5 percent, while Freddie Mac's performance increased even more, by 3.8 percent percentage points, which also led to a record level of 49.9 percent. Fannie Mae's performance was 51.5 percent in 2001, 51.8 percent in 2002, and 52.3 percent in 2003; Freddie Mac's performance was 53.2 percent in 2001, 50.5 percent in 2002, and 51.2 percent in 2003. However, as discussed below, using consistent accounting rules for 2000–03, each GSE's performance in 2001–03 was below its performance in 2000.

The official figures for low-mod goal performance presented above differ from the corresponding figures presented by Fannie Mae and Freddie Mac in their Annual Housing Activity Reports to HUD by 0.2–0.3 percentage point in both 1996 and 1997, reflecting minor differences in the application of counting rules. These differences also persisted for Freddie Mac for 1998–2000, but the goal percentages shown above for Fannie Mae for these three years are the same as the results reported by Fannie Mae to the Department. Fannie Mae reported its performance in 2001 as 51.6 percent and Freddie Mac reported its performance as 53.6 percent—both were slightly above the corresponding official figures of 51.5 percent and 53.4 percent, respectively. For 2002, Fannie Mae's reported performance was the same as reported by HUD (51.8 percent), while Freddie Mac's reported performance was 51.3 percent, slightly above HUD's official figure of 50.5 percent. For 2003, Fannie Mae's reported performance on this goal was 51.8 percent, somewhat below HUD's official figure of 52.3 percent, while Freddie Mac's reported performance (51.1 percent) was essentially the same as HUD's official figure of 51.2 percent.

Fannie Mae's performance on the Low- and Moderate-Income Goal was in the range between 44 percent and 46 percent between 1996 and 1999, but jumped sharply in just one year, from 45.9 percent in 1999 to 49.5 percent in 2000. Freddie Mac's performance was in the range between 41 percent and 43 percent between 1996 and 1998, and then rose to 46.1 percent in 1999 and 49.9 percent in 2000. As discussed above, official performance rose for both GSEs in 2001–02, but this was due to one-time changes in the counting rules—abstracting from counting rule changes, performance fell for both GSEs.

Fannie Mae's performance on the Low- and Moderate-Income Goal surpassed Freddie Mac's in every year through 1998. This pattern was reversed in 1999, as Freddie Mac surpassed Fannie Mae in goal performance for the first time, though by only 0.2 percentage point. This improved relative performance of Freddie Mac was due to its increased purchases of multifamily loans, as it re-entered that market, and to increases in the goal-qualifying shares of its single-family mortgage purchases. Freddie Mac's performance also slightly exceeded Fannie Mae's performance in 2000, 49.9 percent to 49.5 percent. Freddie Mac's official performance also exceeded Fannie Mae's official performance in 2001, but this reflected a difference in the counting rules applicable to the two GSEs that was enacted by Congress; if the same counting rules were applied to both GSEs (that is, Freddie Mac did not receive the 1.35 Temporary Adjustment Factor), Fannie Mae's performance would have exceeded Freddie Mac's performance, by 51.5 percent to 50.5 percent.

In 2002, Freddie Mac's performance on the low mod-goal (50.5 percent) fell short of Fannie Mae's performance (51.8 percent), even though Freddie Mac had the advantage of the Temporary Adjustment Factor. The gap would have been wider without this factor, and in fact Freddie Mac's performance would have been short of the goal, at 49.2 percent. This same pattern prevailed in 2003, when Freddie Mac's performance on this goal (51.2 percent) was significantly below Fannie Mae's performance (52.3 percent), even though Fannie Mae did not have the advantage of the Temporary Adjustment Factor. The gap in performance between the GSEs would have been much wider without this factor, as Freddie Mac's performance would again have fallen short of the goal, at 48.4 percent.

2. Changes in the Goal Counting Rules for 2001–03

A number of changes in the counting rules underlying the calculation of low- and moderate-income goal performance took effect beginning in 2001, as follows:

• *Bonus points for multifamily and single-family rental properties.* During the 2001–03 period the Department awarded ''bonus points'' (double credit in the numerator) for goal-qualifying units in small (5–50 unit) multifamily properties and, above a threshold, 2–4 unit owner-occupied properties whose loans were purchased by the GSEs. By letters dated December 24, 2003, the Department notified the GSEs that these bonus points would not be in effect after December 31, 2003.

• *Freddie Mac's Temporary Adjustment Factor.* As part of the Consolidated Appropriations Act of 2000, Congress required the Department to award 1.35 units of credit for each unit financed in ''large'' multifamily properties (*i.e.*, those with 51 or more units) in the numerator in calculating performance on the housing goals for Freddie Mac for 2001–03.[256] This ''temporary adjustment factor'' (TAF) did not apply to goal performance for Fannie Mae during this period. By letters dated December 24, 2003, the Department notified Freddie Mac that this factor would not be in effect after December 31, 2003.

• *Missing data for single-family properties.* In the past, if a GSE lacked data on rent for rental units or on borrower income for owner-occupied units in single-family properties whose mortgages it purchased, such units were included in the denominator, but not in the numerator, in calculating goal performance. Since some of these units likely would have qualified for one or more of the housing goals, this rule lowered goal performance. Under the new counting rules for the low- and moderate-income goal and the special affordable goal that took effect in 2001, the GSEs are allowed to exclude loans with missing borrower income from the denominator if the property is located in a below-median income census tract. This exclusion is subject to a ceiling of 1 percent of total owner-occupied units financed. The enterprises are also allowed to exclude single-family rental units with missing rental information from the denominator in calculating performance for these two goals; there is no ceiling or restriction to properties located in below-median income census tracts for this exclusion of single-family rental units. No single-family loans can be excluded from the denominator in calculating performance on the underserved areas goal—that is, if a GSE does not have sufficient information to determine whether or not a property is located in an underserved area, all units in such a property are included in the denominator, but not in the numerator, in calculating performance on this goal.

• *Missing data and proxy rents for multifamily properties.* In the past, if a GSE lacked data on rent for rental units in multifamily properties whose mortgages it purchased, such units were included in the denominator, but not in the numerator, in calculating goal performance. Since some of these units likely would have qualified for one or more of the housing goals, this rule lowered goal performance. Under the new counting rules that took effect in 2001, if rent is missing for multifamily units, a GSE may estimate ''proxy rents,'' and, up to a ceiling of 5 percent of total multifamily units financed, may apply these proxy rents in determining whether such units qualify for the low- and moderate income goal and special affordable goal. If such proxy rents cannot be estimated, these multifamily units are excluded from the denominator in calculating performance under these goals. No multifamily loans can be excluded from the denominator in calculating performance on the underserved areas goal—that is, if a GSE does not have sufficient information to determine whether or not a property is located in an underserved area, all units in such a property are included in the denominator, but not in the numerator, in calculating performance on this goal.

• *Purchases of certain government-backed loans.* Prior to 2001, purchases of government-backed loans were not taken into account in determining performance on the GSEs' low- and moderate-income and underserved area housing goals. That is, all such loans were excluded from both the numerator and the denominator in calculating goal performance on these two goals, and in accordance with Section 1333(b)(1)(A) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, purchases of only certain government-backed loans were included in determining performance on the GSEs' special affordable goals. In October 2000 the Department took steps to encourage the enterprises to play more of a role in the secondary market for several types of government-backed loans where it appeared that greater GSE involvement could increase the liquidity of such mortgages. Home equity

[256] See *Congressional Record,* December 15, 2000, pp. H12295–96.

conversion mortgages (HECMs) were developed in the late-1980s by the Federal Housing Administration (FHA); these mortgages allow senior citizens to draw on the equity in their homes to obtain monthly payments to supplement their incomes. Thus purchases of FHA-insured HECMs now count toward the low- and moderate-income housing goals if the mortgagor's income is less than median income for the area. Similarly, purchases of mortgages on properties on tribal lands insured under FHA's Section 248 program or HUD's Section 184 program may qualify for the GSEs' housing goals. And purchases of mortgages under the Rural Housing Service's Single Family Housing Guaranteed Loan Program may also count toward all of the housing goals.[257]

3. *Effects of Changes in the Counting Rules on Goal Performance in 2001–03*

Because of the changes in the low- and moderate-income goal counting rules that took effect in 2001, direct comparisons between official goal performance in 2000 and 2001–03 are somewhat of an ''apples-to-oranges comparison.'' For this reason, the Department has calculated what performance would have been in 2000 under the 2001–03 rules; this may be compared with official performance in 2001–03—an ''apples-to-apples comparison.'' HUD has also calculated what performance would have been in 2001–03 under the 1996–2000 rules; this may be compared with official performance in 2000—an ''oranges-to-oranges comparison.'' These comparisons are presented in Table A.9.

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[257] Prior to the October 2000 rule, purchases of these government-backed mortgages were only eligible for credit under the special affordable goal.

Table A.9

Effects of Counting Rule Changes on the GSEs' Performance on the Low- and Moderate-Income Goal

GSE	Year	Baseline A*	Technical Changes[1]	Baseline B*	Bonus Points: Small MF[2]	Bonus Points: SF Rental[3]	Temporary Adjustment Factor (TAF)[4]	Baseline C*
Fannie Mae	1999	**45.9%**	0.9%	46.8%	0.4%	1.2%	NA	48.4%
	2000	**49.5%**	1.8%	51.3%	0.3%	0.9%	NA	52.5%
	2001	47.7%	1.5%	49.2%	0.7%	1.6%	NA	**51.5%**
	2002	47.4%	1.6%	49.0%	1.2%	1.6%	NA	**51.8%**
	2003	47.1%	1.6%	48.7%	2.0%	1.6%	NA	**52.3%**
	Change, 2002-03	-0.3%	0.0%	-0.3%	0.8%	0.0%	NA	0.5%
Freddie Mac	1999	**46.1%**	0.5%	46.6%	0.1%	1.3%	2.7%	50.7%
	2000	**49.9%**	0.7%	50.6%	0.2%	1.0%	3.3%	55.1%
	2001	47.2%	0.5%	47.7%	1.5%	1.4%	2.7%	**53.2%**
	2002	45.6%	0.5%	46.1%	0.5%	1.8%	2.1%	**50.5%**
	2003	44.4%	0.6%	45.0%	1.2%	2.8%	2.2%	**51.2%**
	Change, 2002-03	-1.8%	0.2%	-1.6%	0.2%	1.1%	0.0%	-0.2%

Details may not add to total due to rounding.

*Note: Baseline A represents performance under 1996-2000 scoring, thus figures for 1999-2000 in bold are official performance in those years. Baseline B adjusts Baseline A for technical changes in counting rules. Baseline C represents performance under 2001-03 scoring, thus figures for 2001-2003 in bold are official performance in those years.

[1] *Technical changes* include credit for purchases of certain qualifying government-backed loans, exclusions of loans with missing information from the denominator in calculating performance, and the use of imputed or proxy rent for multifamily properties.

[2] *Small multifamily bonus points*: For 2001-03, every qualifying unit in a 5-50 unit multifamily property counts as two units in the numerator in calculating goal performance.

[3] *Single-family rental bonus points*: Above a threshold, every qualifying unit in a 2-4 unit property in which one unit is owner-occupied and the other units are rental counts as two units in the numerator in calculating goal performance for 2001-03.

[4] *Temporary adjustment factor (TAF)*: In December 2000 Congress enacted a provision whereby every qualifying unit in a large (> 50 unit) multifamily property counts as 1.35 units in calculating goal performance for Freddie Mac for 2001-03. This provision does not apply to goal performance for Fannie Mae.

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Specifically, Table A.9 shows performance under the low- and moderate-income goal in three ways. Baseline A represents performance under the counting rules in effect in 1996–2000. Baseline B incorporates the technical changes in counting rules—changes in the treatment of missing data (including use of proxy rents), and eligibility for the goals of certain government-backed loans. Baseline C incorporates in addition to the technical changes the bonus points and, for Freddie Mac, the temporary adjustment factor. Baseline B corresponds to the counting approach proposed in this rule to take effect in 2005. Boldface figures under Baseline A for 1999–2000 and under Baseline C for 2001–03 indicate official goal performance, based on the counting rules in effect in those years—*e.g.*, for Fannie Mae, 45.9 percent in 1999, 49.5 percent in 2000, 51.5 percent in 2001, 51.8 percent in 2002, and 52.3 percent in 2003.

• *Performance on the Low- and Moderate-Income Goal under 1996–2000 Counting Rules Plus Technical Changes.* If the ''Baseline B'' counting approach had been in effect in 2000–03 and the GSEs' had purchased the same mortgages that they actually did purchase in those years, both Fannie Mae and Freddie Mac would have surpassed the low- and moderate-income goal in 2000 and fallen short in 2001, 2002, and 2003. Specifically, Fannie Mae's performance would have been 51.3 percent in 2000, 49.2 percent in 2001, 49.0 percent in 2002, and 48.7 percent in 2003. Freddie Mac's performance would have been 50.6 percent in 2000, 47.7 percent in 2001, 46.1 percent in 2002, and 45.0 percent in 2003.

• *Performance on the Low- and Moderate-Income Goal under 2001–2003 Counting Rules.* If the 2001–03 counting rules had also been in effect in 2000 and the GSEs' had purchased the same mortgages that they actually did purchase in those years (*i.e.*, abstracting from any behavioral effects of ''bonus points,'' for example), both GSEs would have substantially surpassed the low- and moderate-income goal in all four years, but both GSEs' performance figures would have deteriorated somewhat from 2000 to 2001, and, for Freddie Mac, from 2001 to 2002 and 2003. Specifically, Fannie Mae's ''Baseline C'' performance would have been 52.5 percent in 2000, 51.5 percent in 2001, 51.8 percent in 2002, and 52.3 percent in 2003. Freddie Mac's performance would have been 55.1 percent in 2000, surpassing its official performance level of 53.2 percent in 2001, 50.5 percent in 2002, and 51.2 percent in 2003. Measured on this consistent basis, then, Fannie Mae's performance fell by 1.0 percentage point in 2001, and Freddie Mac's by 1.9 percentage points in 2001 and an additional 2.0 percentage points in 2002–03. These reductions were primarily due to 2001–03 being years of heavy refinance activity.

Details of Effects of Changes in Counting Rules on Goal Performance in 2001–03. As discussed above, counting rule changes that took effect in 2001 had significant positive impacts on the performance of both GSEs on the low- and moderate-income goal in that year—3.8 percentage points for Fannie Mae, and 6.0 percentage points for Freddie Mac. This section breaks down the effects of these changes on goal performance for both GSEs; results are shown in Table A.9.

• *Freddie Mac.* The largest impact of the counting rule changes on Freddie Mac's goal performance was due to the application of the temporary adjustment factor for purchases of mortgages on large multifamily properties, as enacted by Congress; this added 2.7 percentage points to goal performance in 2001, as shown in Table A.9. Bonus points for purchases of mortgages on small multifamily properties added 1.5 percentage points to performance, and bonus points for purchase of mortgages on owner-occupied 2–4 unit rental properties added 1.4 percentage points to performance. The remaining impact (0.5 percentage point) was due to technical changes in counting rules—primarily, the exclusion of single-family units with missing information from the denominator in calculating goal performance. Credit for purchases of qualifying government-backed loans played a minor role in determining Freddie Mac's goal performance. These same patterns also appeared in 2002. But in 2003, bonus points for purchases of low-mod mortgages on single-family rental properties had a larger impact on Freddie Mae's low-mod goal performance than Freddie Mac's temporary adjustment factor.

• *Fannie Mae.* The temporary adjustment factor applies to Freddie Mac's goal performance, but not to Fannie Mae's performance, thus counting rule changes had less impact on its performance than on Freddie Mac's performance in 2001. The largest impact of the counting rule changes on Fannie Mae's goal performance was due to the application of bonus points for purchases of mortgages on owner-occupied 2–4 unit rental properties, which added 1.6 percentage points to performance, and for purchases of mortgages on small multifamily properties, which added 0.7 percentage point to performance. The remaining impact (1.3 percentage points) was due to technical changes—primarily, the exclusion of single-family units with missing information from the denominator in calculating goal performance.[258] Credit for purchases of qualifying government-backed loans and the use of proxy rent for multifamily properties played a minor role in determining Fannie Mae's goal performance. These same patterns also appeared in 2002 for Fannie Mae, but for 2003 bonus points for purchases of low-mod mortgages on small multifamily properties had more impact on performance than bonus points for single-family rental properties.

4. Bonus Points for the Low- and Moderate-Income Goal

As discussed above, the Department established ''bonus points'' to encourage the GSEs to step up their activity in 2001–03 in two segments of the mortgage market—the small (5–50 unit) multifamily mortgage market, and the market for mortgages on 2–4 unit properties where 1 unit is owner-occupied and 1–3 units are occupied by renters. Bonus points did not apply to purchases of mortgages for owner-occupied 1-unit properties, for investor-owned 1–4 unit properties, and for large (more than 50 units) multifamily properties, although as also discussed above, a ''temporary adjustment factor'' applied to Freddie Mac's purchases of qualifying mortgages on large multifamily properties.

Bonus points for small multifamily properties. Each unit financed in a small multifamily property that qualified for any of the housing goals was counted as two units in the numerator (and one unit in the denominator) in calculating goal performance for that goal. For example, if a GSE financed a mortgage on a 40-unit property in which 10 of the units qualified for the low- and moderate-income goal, 20 units would be entered in the numerator and 40 units in the denominator for this property in calculating goal performance.

Small multifamily bonus points thus encouraged the GSEs to play a larger role in this market, and also to purchase mortgages on such properties in which large shares of the units qualified for the housing goals. Some evidence may be gleaned from the data provided to HUD by the GSEs for 2001–03.

Fannie Mae financed 37,403 units in small multifamily properties in 2001 that were eligible for the low- and moderate-income goal, 58,277 such units in 2002, and 214,619 such units in 2003, as compared with only 7,196 such units financed in 2000. Small multifamily properties also accounted for a greater share of Fannie Mae's multifamily business in 2001–03—7.4 percent of total multifamily units financed in 2001, 13.2 percent in 2002, and 28.6 percent in 2003, up from 2.5 percent in 2000. However, HUD's 2000 rule reported information from the 1991 Residential Finance Survey that small multifamily properties accounted for 37 percent of all multifamily units, thus Fannie Mae was still less active in this market than in the market for large multifamily properties.[259]

Within the small multifamily market, there was no evidence that Fannie Mae targeted affordable properties to a greater extent in 2001–03 than in 2000. That is, 87 percent of Fannie Mae's small multifamily units qualified for the low- and moderate-income goal in 2000; this fell to 75 percent in 2001, rose to 89 percent in 2002, and then declined to 82 percent in 2003.

Freddie Mac financed 50,299 units in small multifamily properties in 2001 that were eligible for the low- and moderate-income goal, 22,255 such units in 2002, and 177,561 such units in 2003, as compared with only such units financed in 2000. Small multifamily properties also accounted for a significantly greater share of Freddie Mac's multifamily business in 2001–2003—16.1 percent of total multifamily units financed in 2001, 7.5 percent in 2002, and 25.4 percent in 2003, up from 1.8 percent in 2000.

Within the small multifamily market, there was some evidence that Freddie Mac targeted affordable properties to a greater extent in 2001–2002 than in 2000. That is, 87 percent

[258] Exclusion of loans with missing information had a greater impact on Fannie Mae's goal performance than on Freddie Mac's goal performance.

[259] **Federal Register**, October 31, 2000, Footnote 145, p. 65141.

of Freddie Mac's small multifamily units qualified for the low- and moderate-income goal in 2000; this rose to 96 percent in 2001, but declined back to 87 percent in 2002 and 2003.

In summary, then, there is strong evidence that bonus points for small multifamily properties had an impact on Fannie Mae's role in this market in 2001–2003 and an even larger impact on Freddie Mac's role in this market. In addition, Fannie Mae has announced a program to increase its role in this market further in future years.[260]

Bonus points for single-family rental properties. Above a threshold, each unit financed in a 2–4 unit property with at least one owner-occupied unit (referred to as ''OO24s'' below) that qualified for any of the housing goals was counted as two units in the numerator (and one unit in the denominator) in calculating goal performance for that goal in 2001–2003. The threshold was equal to 60 percent of the average number of such qualifying units over the previous five years. For example, Fannie Mae financed an average of 50,030 low- and moderate-income units in these types of properties between 1996 and 2000, and 101,423 such units in 2001. Thus Fannie Mae received 71,405 bonus points in this area in 2001—that is, 101,423 minus 60 percent of 50,030. So 172,828 units were entered in the numerator for these properties in calculating low- and moderate-income goal performance.

Single-family rental bonus points thus encouraged the GSEs to play a larger role in this market, and also to purchase mortgages on such properties in which large shares of the units qualified for the housing goals. As for small multifamily bonus points, again some evidence may be gleaned from the data provided to HUD by the GSEs for 2001–03.

Fannie Mae financed 175,103 units in OO24s in 2001 that were eligible for the low- and moderate-income goal, 229,632 such units in 2002, and 355,994 such units in 2003, well above the 77,930 units financed in 2000. However, with the refinance boom, Fannie Mae's total single-family business increased at approximately the same rate as its OO24 business in 2001–03, thus the share of its business accounted for by OO24s was the same in 2001–03 as in 2000—4 percent.

Within the OO24 market, there was no evidence that Fannie Mae targeted affordable properties to a greater extent in 2001–03 than in 2000. That is, approximately 55–60 percent of Fannie Mae's OO24 units qualified for the low- and moderate-income goal in each of these three years.

Freddie Mac financed 96,050 units in OO24s in 2001 that were eligible for the low- and moderate-income goal, 146,222 such units in 2002, and 154,535 such units in 2003, as compared with the 49,993 units financed in 2000. However, Freddie Mac's total single-family business increased at approximately the same rate as its OO24 business in 2001–02, thus the share of its business accounted for by OO24s was the same in 2002 as in 2000—4 percent. And its total single-family business increased at a faster rate than its OO24 business in 2003, thus the share of its business accounted for by OO24s declined to 3 percent last year.

As for Fannie Mae, within the OO24 market there was no evidence that Freddie Mac targeted affordable properties to a greater extent in 2001–03 than in 2000. That is, 68–69 percent of Fannie Mae's OO24 units qualified for the low- and moderate-income goal in each year from 2000 through 2002; this decreased to 64 percent in 2003.

5. Effects of 2000 Census on Scoring of Loans Toward the Low- and Moderate-Income Housing Goal

Background. Scoring of housing units under the Low- and Moderate-Income Housing Goal is based on data for mortgagors' incomes for owner-occupied units, rents for rental units, and area median incomes, as follows:

For single-family owner-occupied units:

The mortgagors' income at the time of mortgage origination.

The median income of an area specified as follows: (i) For properties located in Metropolitan Statistical Areas (MSAs), the area is the MSA; and (ii) for properties located outside of MSAs, the area is the county or the non-metropolitan portion of the State in which the property is located, whichever has the larger median income, as of the year of mortgage origination (which may be for the current year or a prior year).

For rental units in single-family properties with rent data are available (assuming no income data available for actual or prospective tenants):

The unit rent (or average rent for units of the same type) at the time of mortgage origination.

The area median income as specified for single-family owner-occupied units.

For rental units in multifamily properties where rent data are available:

The unit rent (or the average rent for units of the same type) at the time of mortgage acquisition by the GSE.

The area median income as specified for single-family owner-occupied units, but as of the year the GSE acquired the mortgage.

For rental units in multifamily properties where rent data are not available, the GSE may apply HUD-estimated rents which are based on the following area data:

The median rent in the census tract where the property is located, as of the most recent decennial census.

The area median income as specified for single-family owner-occupied units, but as of the most recent decennial census.

Thus, scoring loans under the Low- and Moderate-Income Goal requires a data series showing annual median incomes for MSAs, non-metropolitan counties, and the non-metropolitan portions of states; and decennial census data on median incomes for census tracts.[261]

For scoring loans purchased by the GSEs year-by-year from 1993 through 2002, area median income estimates produced by HUD's Economic and Market Analysis Division were used. An example will illustrate the estimation procedure. To generate the area median income estimates that were used to score GSE loans in 2002, data from the 1990 census on 1989 area median incomes were adjusted to 2002 using Bureau of Labor Statistics survey data on rates of cha nge in average incomes for MSAs and counties between 1989 and 1999, data from the Census Bureau's Current Population Survey on rates of change in median family incomes for the nine Census Divisions between 1989 and 2000, and an assumed 4.0 percent per year inflation factor between 2000 and 2002.[262] [263]

2005 Procedure. Relative to the above procedure, scoring of loans purchased by the GSEs in and after 2005 will be affected by two factors. First, the Economic and Market Analysis Division has begun to incorporate data from the 2000 census into its procedure for estimating annual area median incomes and American Community Survey data are becoming available at increasingly finer levels of geographical detail for use in annual updating. Beginning in 2005 Bureau of Labor Statistics data on rates of inflation in average wages will not be used. For 2005, the procedure for estimating area median incomes will be to adjust 2000 census data on 1999 area median incomes to 2003 using data from the Census Bureau's American Community Survey (ACS) on rates of change in average incomes for States between 1999 and 2003, with a further adjustment to 2005 based on an appropriate annual inflation factor.[264] Increasingly more detailed ACS data will be available and will be used in subsequent years, as ACS estimates for metropolitan and micropolitan areas and counties become available.

The second factor is the Office of Management and Budget's June, 2003, re-

[260] ''Fannie Courting Multifamily Sellers; Small Banks Balking,'' *American Banker,* January 13, 2003, p. 1.

[261] In New England, MSAs were defined through mid-2003 in terms of Towns rather than Counties, and the portion of a New England county outside of any MSA was regarded as equivalent to a county in establishing the metropolitan or non-metropolitan location of a property. The MSA definitions established by the Office of Management and Budget (OMB) in June, 2003 defined MSAs in New England in terms of counties.

[262] The procedure is explained in detail in annual releases entitled ''HUD Methodology for Estimating FY [year] Median Family Incomes'' for years 1993 through 2002, issued by the Economic and Market Analysis Division, Office of Economic Affairs, PD&R, U.S. Department of Housing and Urban Development.

[263] The procedure applicable to the decennial census data used to generate estimated rents is explained in connection with data used to define Underserved Areas in Appendix B.

[264] Transition from the 2002 methodology to the 2005 methodology is occurring in stages in 2003 and 2004. To generate the area median income estimates used to score GSE loans in 2003, data from the 2000 census on 1999 area median incomes were adjusted to 2001 using Bureau of Labor Statistics survey data on rates of change in average incomes for MSAs and counties between 1999 and 2000, data on rates of change in median incomes for the United States and individual States between 1999 and 2001 from Census Bureau's Current Population Survey and American Communities Survey, and an assumed 3.5 percent per year inflation factor between 2001 and 2003. (See ''HUD Methodology for Estimating FY 2003 Median Family Incomes,'' issued by the Economic and Market Analysis Division, *op cit.*) A similar procedure has been used to generate area median income estimates for scoring GSE loans in 2004.

specification of MSA boundaries based on analysis of 2000 census data.[265]

Analysis. For purposes of specifying the level of the Low- and Moderate-Income Housing Goal, HUD developed a methodology for scoring loans purchased by the GSEs in past years through 2002 as though the re-benchmarking of area median income estimates to the 2000 census and the 2003 re-designation of MSAs had been in effect and HUD had been using an ACS-based estimation procedure at the time the estimates for these years were prepared. For this purpose, HUD created a series of annual estimates of median incomes for MSAs, non-metropolitan counties, and the non-metropolitan portions of states. For 2000, the estimates were 1999 census medians trended by three-fourths of the 4.0 percent annual trending factor (to adjust the figures from mid-1999 to April 1, 2000). For 2001, the estimates were based on one-and-three-fourths years of trending, since no data would have been available to use for updating. The 2002 estimates would have used one year of data and 1.75 years of trending. The 2003 estimates would have used two years of data plus 1.75 years of trending. Area median incomes from 1989 to 1999 were estimated based on trend-lines between 1989 and 1999 census data. The 2003 OMB MSA designations were applied.

The resulting estimates of area median incomes for MSAs, non-metropolitan counties, and the non-metropolitan parts of States, were used to re-score loans purchased by the GSEs between 1999 and 2002, and were used further in estimating the share of loans originated in metropolitan areas that would be eligible to score toward the Low- and Moderate-Income Housing Goal, from HMDA data. The results of the retrospective GSE analysis are provided in Table A.10. The results of the GSE-HMDA comparative analysis are presented in the next section.

Table A.10 shows three sets of estimates for each GSE, based respectively on the counting rules in place in 2001–2002 (but disregarding the bonus points and Temporary Adjustment Factor), on the addition of 2000 census re-benchmarking, and finally on the addition of both 2000 census re-benchmarking and 2003 MSA specification. Re-benchmarking occurred to adjust for some differences between Census 1990 and Census 2000 tracts.

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[265] HUD has deferred application of the 2003 MSA specification to 2005, pending completion of the present rulemaking process.

Table A.10

Effects of 2000 Census on Scoring Toward Low- and Moderate-Income Goal

	1999	2000	2001	2002	2003
Fannie Mae:					
Benchmark*	46.8%	51.3%	49.2%	49.0%	48.7%
With 2000 Re-benchmarking	46.9%	51.3%	49.2%	49.1%	48.7%
Adding 2003 MSAs	46.3%	51.2%	48.7%	47.9%	49.5%
Freddie Mac:					
Benchmark*	46.6%	50.6%	47.7%	46.1%	45.0%
With 2000 Re-benchmarking	46.6%	50.6%	47.7%	45.8%	45.0%
Adding 2003 MSAs	46.0%	50.2%	47.0%	44.6%	45.3%

* Benchmark is "Baseline B" performance as shown in Table A.9.

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6. GSEs Compared With the Primary Conventional Conforming Mortgage Market

This section and the next five sections (Sections E.7 to E.12) provide a detailed analysis of the extent to which the GSEs' loan purchases mirror or depart from the patterns found in the primary mortgage market. As in Section C.5, the GSEs' affordable lending performance is also compared with the performance of depository lenders such as commercial banks and thrift institutions. Dimensions of lending considered include the three ''goals-qualifying'' categories—special affordable borrowers, less-than-median income borrowers, and underserved areas. The special affordable category consists mainly of very-low-income borrowers, or borrowers who have an annual income less than 60 percent of area median income. Because this category is more targeted than the broadly-defined less-than-median-income (or low-mod) category, the discussion below will often focus on the special affordable category as well as the underserved areas category which adds a neighborhood dimension (low-income and high-minority census tracts) to the analysis. This section will also compare the performance of Fannie Mae and Freddie Mac in funding first-time homebuyers with that of primary lenders in the conventional conforming market.

The remainder of this introductory section E.6 provides a list of the major and specific findings which are presented in detail in the following Sections E.7 through 12. Sections 7 and 8 define the primary mortgage market and discuss some technical issues related to the use of the GSE and HMDA data. Sections 8 and 9 compare the GSEs' performance with market performance for home purchase and first-time homebuyer loans, while Section 10 does the same for total single family loans (that is, refinance loans and home purchase loans). Section 11 examines GSE purchases in individual metropolitan areas. Following these analyses, Section 12 examines the overall market share of the GSEs in important submarkets such as first-time homebuyers.

a. Main Findings on GSEs' Performance in the Single-family Market

There are six main findings from this analysis concerning the GSEs' purchases of single-family-owner mortgages:

1. While Freddie Mac has improved its affordable lending performance in recent years, it has consistently lagged the conventional conforming market in funding affordable home purchase loans for special affordable and low-moderate-income borrowers and underserved neighborhoods targeted by the housing goals.[266] In 2003, its performance on the underserved areas goal was particularly low relative to both the performances of Fannie Mae and the market; in that year, underserved area loans accounted for only 24.0 percent of Freddie Mac's purchases compared with 26.8 percent of Fannie Mae's purchases and 27.6 percent of market originations.

2. In general, Fannie Mae's affordable lending performance has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance during past periods (*e.g.,* 1993–2003, 1996–2003, 1999–2003) has been below market levels. However, it is encouraging that Fannie Mae markedly improved its affordable lending performance relative to the market during 2001, 2002, and 2003, the first three years under the higher housing goal targets that HUD established in the GSE Final Rule dated October 2000.

Over this three-year period, Fannie Mae led the primary market in funding special affordable and low-mod loans but lagged the market in funding underserved areas loans. In 2003, Fannie Mae's increased performance placed it significantly above the special affordable market (a 17.1 percent share for Fannie Mae compared with a 15.9 percent share for the market) and the low-mod market (a 47.0 percent share for Fannie Mae compared with a 44.6 percent share for the market). However, Fannie Mae continued to lag the underserved areas market in 2003 (a 26.8 percent share for Fannie Mae compared with a 27.6 percent share for the market). In this case, which is referred to in the text as the ''purchase year'' approach, Fannie Mae's performance is based on comparing its purchases of all loans (both seasoned loans and newly-originated mortgages) during a particular year with loans originated in the market in that year. When Fannie Mae's performance is measured on an ''origination year'' basis (that is, allocating Fannie Mae's purchases in a particular year to the year that the purchased loan was originated), Fannie Mae also led the 2003 market in funding special affordable and low- and moderate-income loans, and lagged the market in funding underserved area loans.

3. Both Fannie Mae and Freddie lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

4. The GSEs have accounted for a significant share of the total (government as well as conventional) market for home purchase loans, but their market share for each of the affordable lending categories (*e.g.,* low-income borrowers and census tracts) has been less than their share of the overall market.

5. The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or less than half of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or about one-half of their share (57 percent) of all home purchase loans in that market.

6. The GSEs' small share of the first-time homebuyer market could be due to the preponderance of high (over 20 percent) downpayment loans in their mortgage purchases.

b. Specific Findings on GSE Performance in the Single-family Market

This section presents 17 specific findings from the analyses reported in Sections E.7 through 12; they are grouped under the following five topic-headings:

(b.1) Longer-term Performance of the GSEs;
(b.2) Performance of the GSEs During Recent Years;
(b.3) The GSEs' Funding First-time Homebuyer Loans;
(b.4) Performance of the GSEs Based on Total (Home Purchase and Refinance) Loans;
(b.5) GSE Market Shares; and,
(b.6) Additional Findings.

(b.1) Longer-Term Performance of the GSEs

The longer-run performance of the GSEs is examined between 1993 and 2003 (which covers the period since the housing goals were put into effect) and between 1996 and 2003 (which covers the period under the current definitions of the housing goals). Of the two borrower-income goals, the analysis below will typically focus on the special affordable category, which is a more targeted category than the rather broadly defined low- and moderate-income category.

(1) Since the early nineties, the mortgage industry has introduced new affordable lending programs and has allowed greater flexibility in underwriting lower-income loans. There is evidence that these programs are paying off in terms of more mortgages for low-income and minority borrowers. As noted earlier, Fannie Mae and Freddie Mac have played an active role in this upsurge of affordable lending, as indicated by the high growth rates of their goals-qualifying business.

- Between 1993 and 2003, the GSEs' purchases of home loans in metropolitan areas increased by 60 percent.[267] Their purchases of home loans for the three housing goals increased at much higher rates—287 percent for special affordable loans, 156 percent for low- and moderate-income loans, and 121 percent for loans in underserved census tracts.

(2) Both Fannie Mae and Freddie Mac have improved their purchases of affordable loans since the housing goals were put in place, as indicated by the increasing share of their business going to the three goals-qualifying categories. (See Table A.15 in Section E.9.)

[266] The ''affordable lending performance'' of Fannie Mae and Freddie Mac refers to the performance of the GSEs in funding loans for low-income and underserved borrowers through their purchase (or guarantee) of loans originated by primary lenders. It does not, of course, imply that the GSEs themselves are lenders originating loans in the primary market.

[267] Throughout this analysis, the terms ''home loan'' and ''home mortgage'' will refer to a ''home purchase loan,'' as opposed to a ''refinance loan.'' As noted earlier, the mortgage data reported in this paper are for metropolitan areas, unless stated otherwise. Restricting the GSE data to metropolitan areas is necessary to make it comparable with the HMDA-reported conventional primary market data, which is more reliable for metropolitan areas. The analysis of first-time homebuyers in Sections E.9 and E.12 cover both metropolitan and non-metropolitan areas.

• Between 1992 and 2003, the special affordable share of Fannie Mae's business almost tripled, rising from 6.3 percent to 17.1 percent, while the underserved areas share increased more modestly, from 18.3 percent to 26.8 percent. The figures for Freddie Mac are similar. The special affordable share of Freddie Mac's business rose from 6.5 percent to 15.6 percent, while the underserved areas share also increased but more modestly, from 18.6 percent to 24.0 percent.

(3) While both GSEs improved their performance, they have lagged the primary market in providing affordable loans to low-income borrowers and underserved neighborhoods. Freddie Mac's average performance, in particular, fell far short of market performance during the 1990s. Fannie Mae's average performance was better than Freddie Mac's during the 1993–2003 period as well as during the 1996–2003 period, which covers the period under HUD's currently-defined housing goals.

• Between 1993 and 2003, 12.2 percent of Freddie Mac's mortgage purchases were for special affordable borrowers, compared with 13.3 percent of Fannie Mae's purchases, 15.4 percent of loans originated by depositories, and 15.5 percent of loans originated in the conventional conforming market (without estimated B&C loans).[268]

• Considering the underserved areas category for the 1996–2003 period, 22.0 percent of Freddie Mac's purchases financed properties in underserved neighborhoods, compared with 24.0 percent of Fannie Mae's purchases, 25.1 percent of loans originated by depositories, and 25.7 percent of loans originated in the conventional conforming market.

(b.2) Performance of the GSEs During Recent Years

The recent performance of the GSEs is examined for the four-year period between 1999 and 2003 and then for 2001, 2002 and 2003, which were the first three years that the GSEs operated under the higher goal targets established by HUD in the 2000 Rule. As explained below, the most interesting recent trend concerned Fannie Mae, which improved its performance during 2001–2003, at a time when the conventional conforming market was showing little change in affordable lending.

(4) During the recent 1999-to-2003 period, both Fannie Mae and Freddie Mac fell significantly below the market in funding affordable loans.

• Between 1999 and 2003, special affordable loans accounted for 15.1 percent of Fannie Mae's purchases, 14.7 percent of Freddie Mac's purchases, and 16.2 percent of loans originated in the market; thus, the ''Fannie-Mae-to-market'' ratio was 0.93 and the ''Freddie-Mac-to-market'' ratio was also 0.91.

• During the same period, underserved area loans accounted for 24.7 percent of Fannie Mae's purchases, 23.1 percent of Freddie Mac's purchases, and 26.2 percent of loans originated in the market; the ''Fannie-Mae-to-market'' ratio was 0.94 and the ''Freddie-Mac-to-market'' ratio was only 0.88.[269]

(5) After experiencing declines from 1997 to 1999, Fannie Mae's affordable lending performance improved between 2000 and 2003.

• After declining from 23.0 percent in 1997 to 20.4 percent in 1999, the share of Fannie Mae's purchases financing properties in underserved areas jumped by three percentage points to 23.4 percent in 2000, and then increased further to 26.7 percent in 2002 and 26.8 percent in 2003.

• After declining from 13.2 percent in 1998 to 12.5 percent in 1999, the share of Fannie Mae's purchases going to special affordable loans rebounded to 13.3 percent in 2000, 14.9 percent in 2001, 16.3 percent in 2002 and 17.1 percent in 2003.

(6) Freddie Mac's performance on the two borrower-income categories improved between 2000 and 2002, but not as much as Fannie Mae's performance. Freddie Mac's performance on the underserved areas category increased substantially between 2001 and 2002, but then declined between 2002 and 2003.

• The share of Freddie Mac's single-family-owner business going to special affordable home loans increased from 9.2 in 1997 to 14.7 percent in 2000 before falling to 14.4 percent in 2001 and rising to 15.8 percent in 2002 and 15.6 percent in 2003.

• Freddie Mac's purchases of underserved area loans increased at a modest rate from 19.7 percent in 1997 to 22.3 percent in 2001, before jumping to 25.8 percent in 2002 and then dropping to 24.0 percent in 2003.

(7) The long-standing pattern of Fannie Mae outperforming Freddie Mac was reversed during 1999 and 2000. But that pattern returned in 2001–2003 when Fannie Mae outperformed Freddie Mac on all three goals-qualifying categories.

• Fannie Mae and Freddie Mac had practically the same performance in 1992 on the three housing goal categories—special affordable loans accounted for 6.3 percent of Fannie Mae's purchases and 6.5 percent of Freddie Mac's purchases, for a ''Fannie-Mae-to-Freddie-Mac'' ratio of 0.97. The 1992 ratio for underserved areas was also 0.98 and that for low-mod, 1.02. Reflecting Fannie Mae's much better performance, the special affordable ''Fannie-Mae-to-Freddie-Mac'' ratio had risen to 1.27 by 1997, the underserved area ratio to 1.17, and the low-mod ratio to 1.10.

• However, in 1999, the ''Fannie-Mae-to-Freddie-Mac'' ratio for each of the three goals-qualifying categories fell to slightly below one. 1999 was the first year since 1992 that Freddie Mac had outperformed Fannie Mae in purchasing affordable home loans (although only by a very slight margin).

• In 2000, Freddie Mac's sharper increases in special affordable and low-mod purchases further reduced the ''Fannie-Mae-to-Freddie-Mac'' ratios for these two categories to 0.90 and 0.96, respectively. Fannie Mae's sharper increase in underserved areas funding resulted in the ''Fannie-Mae-to-Freddie-Mac'' ratio rising from slightly below one (0.98) in 1999 to 1.06 in 2000.

• Fannie Mae's stronger performance during 2001–2003 returned the ''Fannie-Mae-to-Freddie-Mac'' ratios for special affordable and low-mod loans to above one (1.10 and 1.09 respectively), indicating better performance for Fannie Mae in 2003. The ''Fannie-Mae-to-Freddie-Mac'' ratio for the underserved area category increased to 1.12 by 2003.

(8) While Freddie Mac has consistently improved its performance relative to the market, it continued to lag the market in funding affordable home loans during 2001–2003.

• Unlike Fannie Mae, Freddie Mac had not made any progress through 1997 in closing its gap with the market. The ''Freddie Mac-to-market'' ratio for the special affordable category actually declined from 0.63 in 1992 to 0.59 in 1996. But Freddie Mac's sharp improvement in special affordable purchases resulted in the ''Freddie-Mac-to-market'' ratio rising to 0.89 by 2000. After declining from 0.84 in 1992 to 0.79 in 1997, the ''Freddie-Mac-to-market'' ratio for underserved areas had risen only modestly to 0.84 by the year 2000. Thus, Freddie Mac's improvements prior to 2001 allowed it to close its gap with the market, mainly for the special affordable category where its gap had been the widest.

• During 2001, 2002 and 2003, Freddie Mac continued to close its gap with the market on the special affordable and low-mod categories. By 2003, these ''Freddie-Mac-to-market'' ratios were higher than in 2000, although they both continued to fall below one: at 0.98 for both categories. Between 2002 and 2003, Freddie Mac's market ratio for underserved areas fell from 0.98 to 0.87 (24.0 percent for Freddie Mac and 27.6 percent for Fannie Mae). Thus, during 2003, Freddie Mac lagged the market on all three goals-qualifying categories.

(9) Through 1998, Fannie Mae had significantly improved its performance relative to the market. But as a result of shifts in its purchases of affordable loans, Fannie Mae lagged the market even further in 2000 than it had in some earlier years. During 2001–2003, Fannie Mae again improved its performance relative to the market and, in 2003, Fannie Mae led the special affordable and low-mod markets but lagged the underserved areas market.

• The above analysis and the data reported under this specific finding (9) are based on the ''purchase year'' approach for measuring GSE activity. The purchase year approach assigns GSE purchases of both prior-year (seasoned) and newly-originated mortgages to the calendar year in which they were purchased by the GSE; this results in an inconsistency with the HMDA-reported market data, which covers only newly-originated mortgages. Sections E.9 and E.10

[268] Unless otherwise noted, the conventional conforming market data reported in this section exclude an estimate of B&C loans; the less-risky A-minus portion of the subprime market is included in the market definition. See Section E.7 and Appendix D for a discussion of primary market definitions and the uncertainty surrounding estimates of the number of B&C loans in HMDA data. As noted there, B&C loans are much more likely to be refinance loans rather than home purchase loans.

[269] Fannie Mae had a particularly poor year during 1999. Therefore, the text also reports averages for 2000–2003, dropping the year 1999 (see Table A.13 in Section E.9).

also report the results of an alternative ''origination year'' approach that assigns GSE purchases to their year of origination, placing them on a more consistent basis with the HMDA-reported market data. The findings from the origination-year approach are discussed under specific finding (10).

- Fannie Mae's decline in performance during 1999 resulted in the ''Fannie-Mae-to-market'' ratio falling sharply to 0.74 for special affordable, to 0.81 for underserved areas and to 0.89 for low-mod. In 2000, Fannie Mae improved and reversed its declining trend, as the ''Fannie-Mae-to-market'' ratios increased to 0.80 for special affordable purchases, to 0.89 for underserved area purchases, and to 0.93 for low-mod purchases.
- During 2001, Fannie Mae increased its special affordable percentage by 1.6 percentage points to 14.9 percent, which was only 0.7 percentage point below the market's performance of 15.6 percent. Fannie Mae increased its low-mod percentage from 40.8 percent to 42.9 percent at the same time that the low-mod share of the primary market was falling from 43.9 percent to 42.9 percent, placing Fannie Mae at the market's performance. Similarly, Fannie Mae increased its underserved area percentage from 23.4 percent in 2000 to 24.4 percent in 2001 while the underserved area share of the primary market was falling from 26.2 percent to 25.2 percent, placing Fannie Mae at 0.8 percentage point from the market's performance.
- During 2002, Fannie Mae continued to improve its performance on all three goals categories. Using the purchase-year approach to measure GSE performance, Fannie Mae slightly led the market on the special affordable category (16.3 percent for Fannie Mae and 16.1 percent for the market), led the market on the low-mod category (45.3 percent for Fannie Mae compared with 44.6 percent for the market), and led the market on the underserved area category (26.7 percent for Fannie Mae versus 26.3 percent for the market).
- During 2003, Fannie Mae's further improvement resulted in Fannie Mae leading the special affordable market (17.1 percent for Fannie Mae compared with 15.9 percent for the market) and continuing to lead the low-mod market (47.0 percent for Fannie Mae compared with 44.6 percent for the market). During 2003, Fannie Mae lagged behind the underserved areas market (26.8 percent for Fannie Mae compared with 27.6 percent for the market).

(10) This analysis addresses several technical issues involved in measuring GSE performance. The above analysis was based on the ''purchase year'' approach, as defined in (9) above. An alternative ''origination year'' approach has also been utilized, which assigns GSE purchases to their year of origination, placing them on a more consistent basis with the HMDA-reported market data. While the average results (*e.g.*, 1999–2003 GSE performance) are similar under the two reporting approaches, GSE performance in any particular year can be affected, depending on the extent to which the GSE has purchased goals-qualifying seasoned loans in that particular year.

- The choice of which approach to follow particularly affected conclusions about Fannie Mae's performance relative to the market in 2002 (but not in 2001). Under the origination-year approach, Fannie Mae lagged the market on all three housing goal categories during 2001 and on the underserved area category during 2002. In 2002, Fannie Mae matched the market on the special affordable category and led the market on the low-mod category (45.5 percent for Fannie Mae compared with 44.6 percent of the market).
- During 2003, the origination year approach gives the similar results as the purchase year approach—Fannie Mae led the special affordable and low-mod markets and lagged the underserved areas market.

(b.3) The GSEs' Funding of First-time Homebuyer Loans

(11) The GSEs' funding of first-time homebuyers has been compared to that of primary lenders in the conventional conforming market. Both Fannie Mae and Freddie lag the market in funding first-time homebuyers, and by a rather wide margin.

- First-time homebuyers account for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

(b.4) Performance of the GSEs Based on Total (Home Purchase and Refinance) Loans

(12) The GSEs' acquisitions of total loans (including refinance loans as well as home purchase loans) were also examined. The main results indicate (a) Freddie Mac has improved its performance but has consistently lagged the market in funding loans (home purchase and refinance) that qualify for the housing goals; and (b) Fannie Mae has not only improved its performance but matched the low-mod market in 2001 and 2002 and led both the special affordable and low-mod markets in 2003. Fannie Mae, however, lagged the primary market in funding underserved areas during 2003. (*See* Table A.20 of Section E.10, which is based on the purchase-year approach for measuring GSE activity.)

- *1999–2003.* During the recent 1999-to-2003 period, both Fannie Mae and Freddie Mac fell significantly below the market in funding affordable total (home purchase and refinance) loans. Between 1999 and 2003, special affordable loans accounted for 14.0 percent of Fannie Mae's purchases, 13.2 percent of Freddie Mac's purchases, and 15.6 percent of loans originated in the market; thus, the ''Fannie-Mae-to-market'' ratio was 0.93 and the ''Freddie-Mac-to-market'' ratio was 0.88 during this period.
- During the same period, underserved area loans accounted for 23.8 percent of Fannie Mae's purchases, 22.1 percent of Freddie Mac's purchases, and 25.2 percent of loans originated in the market; thus, the ''Fannie-Mae-to-market'' ratio was 0.94 and the ''Freddie-Mac-to-market'' ratio was 0.88.[270]
- *2002 and 2003.* During 2002, the first of these two years of heavy refinancing, Fannie Mae's performance was slightly above the market on the low-mod category and slightly below market performance on the special affordable and underserved areas categories; essentially, Fannie Mae matched the market on all three categories in 2002. In 2003, Fannie Mae led the market on the special affordable and low-mod categories and lagged the market on the underserved areas category. The 2003 ''Fannie-Mae-to-market'' ratios were 1.02 for special affordable loans, 1.03 for low-mod loans, and 0.97 for underserved area loans. In 2003, the ''Freddie-Mac-to-market'' ratios were much lower: 0.86 for special affordable loans, 0.90 for low-mod loans, and 0.82 for underserved area loans.

(b.5) GSE Market Shares

This analysis includes an expanded ''market share'' analysis that documents the GSEs'' contribution to important segments of the home purchase and first-time homebuyer markets.

(13) The GSEs account for a significant share of the total (government as well as conventional conforming) market for home purchase loans. However, the GSEs' market share for each of the affordable lending categories is much less than their share of the overall market.

- The GSEs' purchases were estimated to be 46 percent of all home loans originated in metropolitan areas between 1999 and 2003 but only 30 percent of loans originated for African-American and Hispanic borrowers, 38 percent of loans originated for low-income borrowers, and 37 percent for properties in underserved areas. The GSEs' market share for the various affordable lending categories increased during 2001–2003, but the above-mentioned pattern remained.
- A study by staff from the Federal Reserve Board suggests that the GSEs have a much more limited role in the affordable lending market than is suggested by the data presented above.[271] The Fed study, which combined market share, downpayment, and default data, concluded that the GSEs play a very minimal role in providing credit support and assuming credit risk for low-income and minority borrowers; for example, the study concluded that in 1995 the GSEs provided only four percent of the credit support going to African-Americans and Hispanic borrowers.
- Section V of this study begins to reconcile these different results by examining the role of the GSEs in the first-time homebuyer market and the downpayment characteristics of mortgages purchased by the GSEs.

(14) The market role of the GSEs appears to be particularly low in important market segments such as minority first-time homebuyers.

[270] As explained in Section E.9, deducting B&C loans from the market totals has more impact on the market percentages for total (both home purchase and refinance) loans than for only home purchase loans. The effects of excluding B&C loans from the total market can be seen by comparing the third and sixth columns of data in Table A.19 in Section E.10.

[271] See Glenn B. Canner, Wayne Passmore, and Brian J. Surette, ''Distribution of Credit Risk Among Providers of Mortgages to Lower-Income and Minority Homebuyers'' in *Federal Reserve Bulletin,* 82(12): 1077–1102, December, 1996.

• Recent analysis has estimated that the GSEs' share of the market for first-time African-American and Hispanic homebuyers was only 14.3 percent between 1999 and 2001, or about one-third of their share (41.5 percent) of all home purchases during that period. This analysis includes the total market, including government and conventional loans.

• A similar market share analysis was conducted for the conventional conforming market. Between 1999 and 2001, the GSEs' purchases accounted for 56.6 percent of all home loans originated in the conventional conforming market of both metropolitan areas and non-metropolitan areas. Their purchases of first-time homebuyer loans, on the other hand, accounted for only 39.8 percent of all first-time homebuyer loans originated in that market.

• The GSEs have funded an even lower share of the minority first-time homebuyer market in the conventional conforming market. Between 1999 and 2001, the GSEs purchases of African-American and Hispanic first-time homebuyer loans represented 30.9 percent of the conventional conforming market for these loans. Thus, while the GSEs have accounted for 56.6 percent of all home loans in the conventional conforming market, they have accounted for only 30.9 percent of loans originated in that market for African-American and Hispanic first-time homebuyers.

(15) A noticeable pattern among the lower-income-borrower loans purchased by the GSEs is the predominance of loans with high downpayments. This pattern of purchasing mainly high downpayment loans is one factor explaining why the Fed study found such a small market role for the GSEs. It may be the explanation for the small role of Fannie Mae and Freddie Mac in the first-time homebuyer market. Further study of this issue is needed.

• During 2001 and 2002, approximately 50 percent of Fannie Mae's special affordable, low-mod, and underserved areas loans had downpayments of at least 20 percent, a percentage only slightly smaller that the corresponding percentage (53 percent) for all Fannie Mae's home loan purchases. Similar patterns of above-20-percent downpayments on goals-qualifying loans were evident in Freddie Mac's 2001, 2002, and 2003 purchases, as well as in prior years for both GSEs. During 2003, Fannie Mae's high downpayment share of their special affordable purchases dropped to 45 percent while the patterns for Fannie Mae's low-mod and underserved area purchases did not change, remaining about 50 percent.

(b.6) Additional Findings

This analysis examines two additional topics related to minority first-time homebuyers and the use of HMDA data for measuring the characteristics of loans originated in the conventional conforming market.

(16) The share of the GSEs' purchases for minority first-time homebuyers was much less than the share of newly-originated mortgages in the conventional conforming market for those homebuyers.

• Between 1999 and 2001, minority first-time homebuyers accounted for 6.6 percent of Fannie Mae's purchases of home loans, 5.8 percent of Freddie Mac's purchases, and 10.6 percent of home loans originated in the conventional conforming market. For this subgroup, Fannie Mae's performance is 62 percent of market performance, while Freddie Mac's performance is 55 percent of market performance.

(17) Some studies have concluded that HMDA data overstate the share of market loans going to low-income borrowers and underserved areas. This analysis does not support that conclusion.

• This compares the low-income and underserved areas characteristics of the GSEs' purchases of newly-originated (''current-year'') loans as reported both by the GSEs'' own data and by HMDA data.[272] For recent years, HMDA data on loans sold to the GSEs do not always have higher percentages of low-income and underserved areas loans than the GSEs' own data on their purchases of newly-originated mortgages. For example, from 1996–2003, both HMDA and Fannie Mae reported that special affordable loans accounted for about 13 percent of Fannie Mae's purchases of newly-originated loans. HMDA reported a 22.6 underserved areas percentage for Fannie Mae, which was rather similar to the underserved areas percentage (23.1 percent) reported by Fannie Mae itself. Given that similar patterns were observed for Freddie Mac's mortgage purchases, it appears that there is no upward bias in the HMDA-based market benchmarks used in this study.

7. Definition of Primary Market

Conventional Conforming Market. The market analysis section is based mainly on HMDA data for mortgages originated in the conventional conforming market of metropolitan areas during the years 1992 to 2003. Only conventional loans with a principal balance less than or equal to the conforming loan limit are included; the conforming loan limit was $322,700 in 2003—these are called ''conventional conforming loans.'' The GSEs' purchases of FHA-insured, VA-guaranteed, and Rural Housing Service loans are excluded from this analysis. The conventional conforming market is used as the benchmark against which to evaluate the GSEs because that is the market definition Congress requires that HUD consider when setting the affordable housing goals. However, as discussed in Section II, some have questioned whether lenders in the conventional market are doing an adequate job meeting the credit needs of minority borrowers, which suggests that this market provides a low benchmark.[273]

Manufactured Housing Loans. Both GSEs have raised questions about whether loans on manufactured housing should be excluded when comparing the primary market with the GSEs. The GSEs purchase these loans, but they have not played a significant role in the manufactured housing loan market. As emphasized by HUD in its 2000 GSE Rule, manufactured housing is an important source of home financing for low-income families and for that reason, should be included in any analysis of affordable lending. However, for comparison purposes, data are also presented for the primary market defined without manufactured housing loans. Because this analysis focuses on metropolitan areas, it does not include the substantial number of manufactured housing loans originated in non-metropolitan areas.

Subprime Loans. Both GSEs also raised questions about whether subprime loans should be excluded when comparing the primary market with their performance. In its final 2000 GSE Rule, HUD argued that borrowers in the A-minus portion of the subprime market could benefit from the standardization and lower interest rates that typically accompany an active secondary market effort by the GSEs. A-minus loans are not nearly as risky as B&C loans and the GSEs have already started purchasing A-minus loans (and likely the lower ''B'' grade subprime loans as well). The GSEs themselves have mentioned that a large portion of borrowers in the subprime market could qualify as ''A credit.'' This analysis includes the A-minus portion of the subprime market, or conversely, excludes the B&C portion of that market.

Unfortunately, HMDA does not identify subprime loans, much less separate them into their A-minus and B&C components.[274] Randall M. Scheessele at HUD has identified approximately 200 HMDA reporters that primarily originate subprime loans and account for about 60–70 percent of the subprime market.[275] To adjust HMDA data for B&C loans, this analysis follows HUD's 2000 Rule which assumed that the B&C portion of the subprime market accounted for one-half of the loans originated by the subprime lenders included in Scheessele's list.[276] As shown below, the effects of

[272] In this comparison, a higher special affordable percentage for HMDA-reported mortgage originations that lenders report as also being sold to the GSEs—as compared with the special affordable percentage for newly-originated mortgages that the GSEs report as being actually purchased by them—would suggest that HMDA market data are biased; that is, in this situation, the special affordable percentage for all mortgage originations reported in HMDA would likely be larger than the special affordable percentage for all new mortgage originations, including those not reported in HMDA as well as those reported in HMDA.

[273] The market definition in this section is narrower than the ''Total Market'' data presented earlier in Tables A.1 and A.2, which included all home loans below the conforming loan limit, that is, government loans as well as conventional conforming loans. The market share analysis reported in Section E.12 also examine the GSEs' role in the overall market.

[274] And there is some evidence that many subprime loans are not even reported to HMDA, although there is nothing conclusive on this issue. See *Fair Lending/CRA Compass,* June 1999, p. 3.

[275] The list of subprime lenders as well as Scheessele's list of manufactured housing lenders are available at *http://www.huduser.org/publications/hsgfin.html.*

[276] The one-half estimate is conservative as some observers estimate that B&C loans account for only 30–40 percent of the subprime market. However, varying the B&C share from 50 percent to 30 percent does not significantly change the following analysis of home purchase loans because subprime loans are mainly for refinance purposes. Overstating the share of B&C loans in this manner also allows for any differences in HMDA reporting of different

Continued

adjusting the various market percentages for B&C loans are minor mostly because the analysis in this section focuses on home purchase loans, which historically have accounted for less than one quarter of the mortgages originated by subprime lenders—the subprime market is mainly a refinance market.[277]

Lender-Purchased Loans in HMDA. When analyzing HMDA data, Fannie Mae includes in its market totals those HMDA loans identified as having been purchased by the reporting lender, above and beyond loans that were originated by the reporting lender.[278] Fannie Mae contends that there are a subset of loans originated by brokers and subsequently purchased by wholesale lenders that are neither reported by the brokers nor the wholesale lenders as originations but are reported by the wholesale lenders as purchased loans. According to Fannie Mae, these HMDA-reported purchased loans should be added to HMDA-reported originated loans to arrive at an estimate of total mortgage originations.

This rule's market definition includes only HMDA-reported originations; purchased loans are excluded from the market definition. While some purchased loans may not be reported as originations in HMDA (the Fannie Mae argument), there are several reasons for assuming that most HMDA-reported purchased loans are also reported in HMDA as market originations. *First,* Fed staff have told HUD that including purchased loans would result in double counting mortgage originations.[279] *Second,* comparisons of HMDA-reported FHA data with data reported by FHA supports the Fed's conclusion. For instance, FHA's own data indicate that during 2001 FHA insured 752,319 home purchase loans in metropolitan areas; the sum of HMDA-reported purchased home loans and HMDA-reported originated home loans in metropolitan areas alone yields a much higher figure of 845,176 FHA-insured loans during 2001.[280] While these calculations are for the FHA market (rather than the conventional market), they suggest that including HMDA-reported purchased loans in the market definition would overstate mortgage origination totals. *Third,* Abt Associates surveyed nine wholesale lenders and questioned them concerning their guidelines for reporting in HMDA loans purchased from brokers. Most of these lenders said brokered loans were reported as originations if they [the wholesale lender] make the credit decision; this policy is consistent with the Fed's guidelines for HMDA reporting. Abt Associates concluded that ''brokered loans do seem more likely to be reported as originations * * *.''[281]

Finally, it should be noted that including purchased loans in the market definition does not significantly change the goals-qualifying shares of the market, mostly because borrower income data are missing for the majority of purchased loans. In addition, the low-income and underserved area shares for purchased and originated loans are rather similar. In 2001, the following differences in shares for the conventional conforming home purchase market were obtained for purchased and originated loans: Low-income (25.8 percent for purchased loans, 28.3 percent for market originations), low-mod income (41.3 percent, 43.2 percent), and underserved areas (24.2 percent, 25.8 percent). The comparisons were also similar for 2002.[282]

8. Technical Issues: Using HMDA Data To Measure the Characteristics of GSE Purchases and Mortgage Market Originations[283]

This section discusses important technical issues concerning the use of HMDA data for measuring the GSEs' performance relative to the characteristics of mortgages originated in the primary market. The first issue concerns the reliability of HMDA data for measuring the borrower income and census tract characteristics of loans sold to the GSEs. Fannie Mae, in particular, has contended that HMDA data understates the percentages of its business that qualify for the three housing goals. In its comments on the proposed 2000 Rule, Fannie Mae questioned HUD's reliance on HMDA data for measuring its performance. As discussed below, HMDA data on loans sold to the GSEs do not include prior-year (seasoned) loans that are sold to the GSEs. Since about one-fourth of GSE purchases in any particular year involve loans originated in prior years, HMDA data will not provide an accurate measure of the goals-qualifying characteristics of the GSEs' total purchases when the characteristics of prior-year loans differ from those of newly-originated, current-year loans.

A related issue concerns the appropriate definition of the GSE data when making annual comparisons of GSE performance with the market. On the one hand, the GSE annual data can be expressed on a purchase-year basis, which means that all GSE purchases in a particular year would be assigned to that particular year. Alternatively, the GSE annual data can be expressed on an origination-year basis, which means that GSE purchases in a particular year would be assigned to the calendar year that the GSE-purchased mortgage was originated; for example, a GSE's purchase during 2001 of a loan originated in 1999 would be assigned to 1999, the year the loan was originated. These two approaches are discussed further below.

A final technical issue concerns the reliability of HMDA for measuring the percentage of goals-qualifying loans in the primary market. Both GSEs refer to findings from a study by Jim Berkovec and Peter Zorn concerning potential bias in HMDA data.[284] Based on a comparison of the borrower and census tract characteristics between Freddie-Mac-purchased loans (from Freddie Mac's own data) and loans identified in 1993 HMDA data as sold to Freddie Mac, Berkovec and Zorn conclude that HMDA data overstate the percentage of conventional conforming loans originated for lower-income borrowers and for properties located in underserved census tracts. If HMDA data overstate the percentage of goals-qualifying loans, then HUD's market benchmarks (which are based on HMDA data) will also be overstated. The analysis below does not support the Berkovec and Zorn findings—it appears that HMDA data do not overstate the share of goals-qualifying loans in the market. The discussion below of the GSEs' purchases of prior-year and current-year loans also highlights the strategy of purchasing seasoned loans that qualify for the housing goals. The implications of this strategy for understanding recent shifts in the relative performance of Fannie Mae and Freddie Mac are discussed below in Section E.9.

a. GSEs' Purchases of ''Prior-Year'' and ''Current-Year'' Mortgages

There are two sources of loan-level information about the characteristics of mortgages purchased by the GSEs—the GSEs themselves and HMDA data. The GSEs provide detailed data on their mortgage purchases to HUD on an annual basis. As part of their annual HMDA reporting responsibilities, lenders are required to indicate whether their new mortgage originations or the loans that they purchase (from affiliates and other institutions) are sold to Fannie Mae, Freddie Mac or some

types of loans—for example, if B&C loans account for 35 percent of all subprime loans, then assuming that they account for 50 percent is equivalent to assuming that B&C loans are reported in HMDA at 70 percent of the rate of other loans.

[277] The reductions in the market shares are more significant for total loans, which include refinance as well as home purchase loans; for data on total loans, see Table A.19 in Section 10. Subprime lenders have been focusing more on home purchase loans recently. The home purchase share of loans originated by the subprime lenders in Scheessele's list increased from 26 percent in 1999 to 36 percent in 2000 before dropping to about 30 percent during the heavy refinancing years of 2001 and 2002.

[278] In 2001 (2002), lenders reported in HMDA that they purchased 851,735 (906,684) conventional conforming, home purchase loans in metropolitan areas; this compares with 2,763,230 (2,929,197) loans that these same lenders reported that they originated in metropolitan areas.

[279] See Randall M. Scheessele, *HMDA Coverage of the Mortgage Market,* Housing Finance Working Paper No. HF–007. Office of Policy Development and Research, U.S. Department of Housing and Urban Development, July, 1998.

[280] In this example, HMDA-reported purchased loans insured by FHA have been reduced from 411,930 to 100,251 by a procedure that accounts for missing data and overlapping purchased and originated loans. See Harold L. Bunce, *The GSEs' Funding of Affordable Loans: A 2000 Update,* Working Paper HF–013, Office of Policy Development and Research, HUD, April 2002, for an alternative analysis showing that a market estimate based on adding HMDA-reported purchased loans to HMDA-reported originations would substantially overstate the volume of FHA mortgage originations in metropolitan areas.

[281] See Chapter III, ''Reporting of Brokered and Correspondent Loans under HMDA'', in *Exploratory Study of the Accuracy of HMDA Data,* by Abt Associates Inc. under contract for the Office of Policy Development and Research, HUD, February 12, 1999, page 18.

[282] The percentage shares for purchased loans are obtained after eliminating purchased loans without data and purchased loans that overlap with originated loans. The calculations included 138,536 purchased loans for 2001 and 182,290 purchased loans for 2002.

[283] Readers not interested in these technical issues may want to proceed to Section E.9, which compares GSE performance to the primary market.

[284] See Jim Berkovec and Peter Zorn, ''How Complete is HMDA? HMDA Coverage of Freddie Mac Purchases,'' *The Journal of Real Estate Research,* Vol. II, No. 1, Nov. 1, 1996.

other entity. There have been numerous studies by HUD staff and other researchers that use HMDA data to compare the borrower and neighborhood characteristics of loans sold to the GSEs with the characteristics of all loans originated in the market. One question is whether HMDA data, which is widely available to the public, provides an accurate measure of GSE performance, as compared with the GSEs' own data.[285] Fannie Mae has argued that HMDA data understate its past performance, where performance is defined as the percentage of Fannie Mae's mortgage purchases accounted for by one of the goal-qualifying categories. As explained below, over the past six years, HMDA has provided rather reliable national-level information on the goals-qualifying percentages for the GSEs' purchases of ''current-year'' (*i.e.*, newly-originated) loans, but not for their purchases of ''prior-year'' loans.[286]

In any given calendar year, the GSEs can purchase mortgages originated in that calendar year or mortgages originated in a prior calendar year. In 2001 and 2002, for example, purchases of prior-year mortgages accounted for approximately 20 percent of the home loans purchased by each GSE.[287] HMDA data provide information mainly on newly-originated mortgages that are sold to the GSEs—that is, HMDA data on loans sold to the GSEs will not include many of their purchases of prior-year loans. The implications of this for measuring GSE performance can be seen in Table A.11, which provides annual data on the borrower and census tract characteristics of GSE purchases, as measured by HMDA data and by the GSEs' own data. Table A.11 divides each of the GSEs' goals-qualifying percentages for a particular acquisition year into two components, the percentage for ''prior-year'' loans and the percentage for ''current-year'' loans.

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[285] For another discussion of this issue, see Randall M. Scheessele, *HMDA Coverage of the Mortgage Market,* Housing Finance Working Paper HF–007, Office of Policy Development and Research, Department of Housing and Urban Development, July 1998. Scheessele reports that HMDA data covered 81.6 percent of the loans acquired by Fannie Mae and Freddie Mac in 1996. The main reason for the under-reporting of GSE acquisitions is a few large lenders failed to report the sale of a significant portion of their loan originations to the GSEs. Also see the analysis of HMDA coverage by Jim Berkovec and Peter Zorn. ''Measuring the Market: Easier Said than Done,'' *Secondary Mortgage Markets.* McLean VA: Freddie Mac, Winter 1996, pp. 18–21; as well as the Berkovec and Zorn study cited in the above footnote.

[286] Between 1993 and 1996, the GSEs' purchases of prior-year loans were not as targeted as they were after 1996; thus, during this period, HMDA provided reasonable estimates of the goals-qualifying percentages of the GSEs' purchases of all (both current-year and prior-year) loans, with a few exceptions (see Table A.11).

[287] The ''prior-year'' share dropped to 16 percent during the heavy refinancing year of 2003. During the 1990s, the GSEs increased their purchases of seasoned loans; see Paul B. Manchester, *Goal Performance and Characteristics of Mortgages Purchased by Fannie Mae and Freddie Mac, 1998–2000,* Housing Finance Working Paper No. HF–015, Office of Policy Development and Research, HUD, May 2001.

Table A.11

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas Goal-Qualifying Home Purchase Mortgages, 1992-2003

Borrower and Tract Characteristics	Fannie Mae Data Prior Year	Fannie Mae Data Current Year	Fannie Mae Data All	HMDA Data for Fannie Mae	Freddie Mac Data Prior Year	Freddie Mac Data Current Year	Freddie Mac Data All	HMDA Data for Freddie Mac	Conforming Market (W/O B&C Loans[1])
Special Affordable									
1992				6.3				6.5	10.4
1993	8.3	8.2	8.2	8.8	5.1	7.5	7.3	7.8	12.6
1994	9.7	10.9	10.7	11.4	7.7	8.2	8.2	9.2	14.1
1995	13.4	11.0	11.4	10.5	9.3	8.3	8.4	8.9	14.4
1996	10.8	10.3	10.4	10.5	8.5	8.9	8.8	9.4	15.0
1997	16.1	10.3	11.7	10.5	9.3	9.1	9.2	9.4	15.1
1998	18.1	12.0	13.2	10.7	12.1	11.4	11.5	9.7	15.4
1999	12.1	12.6	12.5	12.5	13.2	12.7	12.8	12.6	17.0
2000	13.5	13.2	13.3	13.7	17.9	13.4	14.7	13.3	16.6
2001	18.1	14.2	14.9	13.4	17.9	13.3	14.4	12.3	15.6
2002	18.8	15.8	16.3	15.5	15.8	15.8	15.8	14.5	16.1
2003	18.7	16.8	17.1	16.3	17.4	15.3	15.6	13.8	15.9
Less Than Area Median Income									
1992				29.2				28.7	34.4
1993	30.8	33.8	33.5	35.0	25.2	32.5	31.9	32.3	38.9
1994	36.1	39.4	38.8	40.1	32.0	34.1	33.7	35.6	41.8
1995	39.0	38.2	38.3	37.1	34.2	32.5	32.8	33.9	41.4
1996	36.0	37.3	37.0	37.7	32.3	34.1	33.7	35.3	42.2
1997	42.3	37.0	38.3	37.5	34.2	34.8	34.7	35.4	42.1
1998	45.9	39.6	40.9	38.1	36.9	37.7	37.6	36.2	42.8
1999	38.0	40.6	40.0	40.2	39.4	41.2	40.8	41.0	44.8
2000	39.8	41.1	40.8	42.0	47.3	40.9	42.7	41.3	43.9
2001	45.3	42.3	42.9	41.5	43.8	40.5	41.3	39.2	42.9
2002	45.3	45.4	45.3	45.6	42.4	44.4	44.0	43.5	44.6
2003	47.0	47.0	47.0	46.5	45.7	43.5	43.8	41.7	44.6
Underserved Areas									
1992				18.3				18.6	22.2
1993	23.8	19.3	20.3	18.2	19.4	18.0	18.2	17.6	21.9
1994	26.5	23.5	24.2	22.5	21.0	19.2	19.6	19.2	24.3
1995	27.4	23.8	24.6	22.8	22.3	19.2	19.9	19.1	25.4
1996	23.4	21.8	22.3	21.6	22.2	18.9	19.6	19.0	24.9
1997	29.1	20.6	23.0	21.0	22.1	19.1	19.7	18.6	24.8
1998	28.3	20.8	22.7	19.6	21.9	19.3	19.8	17.4	24.2
1999	21.9	20.0	20.4	20.3	23.1	20.3	20.9	19.3	25.2
2000	26.6	22.4	23.4	22.5	23.9	21.2	22.0	20.9	26.2
2001	28.3	23.3	24.4	22.0	25.7	21.3	22.3	19.5	25.2
2002	32.7	25.5	26.7	24.6	29.4	25.0	25.8	21.4	26.3
2003	29.5	26.3	26.8	25.5	28.0	23.4	24.0	20.3	27.6

Notes: The Fannie Mae and Freddie Mac data for their purchases of "Prior Year" mortgages, "Current Year" mortgages, and "All" mortgages are from the loan-level data that they provide to HUD. All mortgages are conventional conforming home purchase mortgages. The "HMDA Data for (GSE)" are those mortgages that HMDA identifies as being sold to the GSEs. The Conforming Market data are from HMDA data. Mortgages with a loan amount greater than six times borrower income are excluded for the purposes of the low- and moderate-income and special affordable analyses. In both the GSE and market analyses, mortgages classified as special affordable include mortgages from very-low-income borrowers and low-income borrowers living in low-income census tracts. Because missing value percentages differ between GSE and HMDA data, mortgages with missing data are excluded from both the GSE and market data.

[1] The adjustment assumes that B&C loans represent one-half of the subprime market. The adjustment for home purchase loans is small because subprime (B&C) loans are mainly refinance loans. For further discussion, see text.

Consider Fannie Mae's special affordable purchases in 2002. According to Fannie Mae's own data, 16.3 percent of its purchases during 2002 were special affordable loans. According to HMDA data, only 15.5 percent of loans sold to Fannie Mae fell into the special affordable category. In this case, HMDA data underestimate the special affordable share of Fannie Mae's purchases during 2002. What explains these different patterns in the GSE and HMDA data? The reason that HMDA data underestimate the special affordable percentage of Fannie Mae's 2002 purchases can be seen by disaggregating Fannie Mae's purchases during 2002 into their prior-year and current-year components. Table A.11 shows that the overall figure of 16.3 percent for special affordable purchases is a weighted average of 18.8 percent for Fannie Mae's purchases during 2002 of prior-year mortgages and 15.8 percent for its purchases of current-year purchases. The HMDA-reported figure of 15.5 percent is based mainly on newly-mortgaged (current-year) loans that lenders reported as being sold to Fannie Mae during 2002. The HMDA figure is similar in concept to the current-year percentage from the GSEs' own data. And the HMDA figure and the GSE current-year figure are practically the same in this case (15.5 versus 15.8 percent). Thus, the relatively large share of special affordable mortgages in Fannie Mae's purchases of prior-year mortgages explains why Fannie Mae's own data show an overall (both prior-year and current-year) percentage of special affordable loans that is higher than that reported for Fannie Mae in HMDA data.

b. Reliability of HMDA Data

With the above explanation of the basic differences between GSE-reported and HMDA-reported loan information, issues related to the reliability of HMDA data can now be discussed. Table A.12 presents the same information as Table A.11, except that the data are aggregated for the years 1993–5, 1996–2003, and 1999–2003. Comparing HMDA-reported data on GSE purchases with GSE-reported current-year data suggests that, on average, HMDA data have provided reasonable estimates of the goals-qualifying percentages for the GSEs' current-year purchases (with the exception of Freddie Mac's underserved area loans, as discussed below). For example, Fannie Mae reported that 13.7 percent of the current-year loans it purchased between 1996 and 2003 were for special affordable borrowers. In their HMDA submissions, lenders reported a nearly identical figure of 13.4 percent for the special affordable share of loans that they sold to Fannie Mae. The corresponding numbers for Freddie Mac were 12.8 percent reported by them and 12.1 percent reported by HMDA. During the same period, both Fannie Mae and HMDA reported that approximately 23 percent of current-year loans purchased by Fannie Mae financed properties in underserved areas. However, Freddie Mac reported that 21.3 percent of the current-year loans it purchased between 1996 and 2003 financed properties in underserved areas, a figure somewhat higher than the 19.6 percent that HMDA reported as underserved area loans sold to Freddie Mac during that period.[288]

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[288] Freddie Mac's underserved area figures for 2002 and 2003 showed particularly large discrepancies. As shown in Table A.11, Freddie Mac reported that 25.0 (23.4) percent of the current-year loans it purchased during 2002 (2003) financed properties in underserved areas, a figure much higher than the 21.4 (20.3) percent that HMDA reported as underserved area loans sold to Freddie Mac during 2002. These discrepancies are the largest in Table A.11, and it is not clear what explains them. This downward bias for HMDA data, is the opposite of that suggested by Berkovec and Zorn, who argued that affordability percentages from HMDA data are biased upward.

Table A.12

HMDA Versus GSE Reporting of GSE Loan Characteristics Single-Family-Owner Home Loans in Metropolitan Areas, 1993-2003

	Fannie Mae			Freddie Mac		
Borrower and Tract Characteristics	GSE-Reported Current-Year Loan Purchases	HMDA-Reported GSE Purchases	Ratio: HMDA-Reported/ GSE Reported	GSE-Reported Current-Year Loan Purchases	HMDA-Reported GSE Purchases	Ratio: HMDA-Reported/ GSE Reported
Special Affordable						
1993-1995	9.9	10.2	1.03	8.0	8.6	1.08
1996-2003	13.7	13.4	0.98	12.8	12.1	0.95
1999-2003	14.8	14.6	0.99	14.2	13.3	0.94
Less than Area Median Income						
1993-1995	36.8	37.2	1.01	33.0	33.9	1.03
1996-2003	42.1	42.0	1.00	40.1	39.5	0.99
1999-2003	43.7	43.7	1.00	42.2	41.3	0.98
Underserved Areas						
1993-1995	22.0	21.1	0.96	18.8	18.6	0.99
1996-2003	23.1	22.6	0.98	21.3	19.6	0.92
1999-2003	23.9	23.3	0.97	22.4	20.3	0.91

Source: The Fannie Mae and Freddie Mac "current year" data include information on their purchases of home loan originated in the same year they acquired the loans. The data are from the loan-level data that they provide to HUD. All mortgages are conventional conforming mortgages. The "HMDA-Reported" data include information on conventional conforming loans sold to the GSEs as reported by lenders in HMDA. Loans with a loan-to-income ratio greater than six are excluded from the borrower income calculations. Special affordable includes very low-income borrowers and low-income borrowers in low-income census tracts. Data with missing values are excluded.

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The facts that the Fannie Mae and HMDA figures for special affordable, low-mod and underserved area loans are similar, and that the Freddie Mac discrepancies are the result of Freddie Mac reporting higher percentages than HMDA, suggest that the Berkovec and Zorn conclusions about HMDA being upward biased are wrong.[289] For the 1996-to-2003 period, the discrepancies reported in Table A.11 as well as Table A.12 are mostly consistent with HMDA being biased in a downward direction, not an upward direction as Berkovec and Zorn contend.[290] In particular, the Freddie-Mac-reported underserved area percentage (as well as its special affordable percentage) being larger than the HMDA-reported underserved area percentage suggests a downward bias in HMDA. The more recent and complete (Fannie Mae data as well as Freddie Mac data) analysis does not support the Berkovec and Zorn finding that HMDA overstates the goals-qualifying percentages of the market.[291]

c. Purchase-Year Versus Origination-Year Reporting of GSE Data

In comparing the GSEs' performance to the primary market, HUD has typically expressed the GSEs' annual performance on a purchase-year basis. That is, all mortgages (including both current-year mortgages and prior-year mortgages) purchased by a GSE in a particular year are assigned to the year of GSE purchase. The approach of including a GSE's purchases of both ''current-year'' and ''prior-year'' mortgages gives the GSE full credit for their purchase activity in the year that the purchase actually takes place; this approach is also consistent with the statutory requirement for measuring GSE performance under the housing goals. However, this approach results in an obvious ''apples to oranges'' problem with respect to the HMDA-based market data, which include only newly-originated mortgages (*i.e.*, current-year mortgages). To place the GSE and market data on an ''apples to apples'' basis, HUD has also used an alternative approach that expresses the GSE annual data on an origination-year basis. In this case, all purchases by a GSE in any particular year would be fully reported but they would be allocated to the year that they were originated, rather than to the year they were purchased. Under this approach, a GSE's data for the year 2000 would not only include that GSE's purchases during 2000 of newly-originated mortgages but also any year-2000-originations purchased in later years (*i.e.*, during 2001, 2002 and 2003 in this analysis). This approach places the GSE and the market data on a consistent, current-year basis. In the above example, the market data would present the income and underserved area characteristics of mortgages originated in 2000, and the GSE data would present the same characteristics of all year-2000-mortgages that the GSE has purchased to date (*i.e.*, through year 2003).[292]

Below, results will be presented for both the purchase-year and origination-year approaches. Following past HUD studies that have compared GSE performance with the primary market, most of the analysis in this section reports the GSE data on a purchase-year basis; however, the main results are repeated with the GSE data reported on an origination-year basis. This allows the reader to compare any differences in findings about how well the GSEs have been doing relative to the market.

9. Affordable Lending by the GSEs: Home Purchase Loans

This section compares the GSEs' affordable lending performance with the primary market for the years 1993–2003. The analysis in this section begins by presenting the GSE data on a purchase-year basis. As discussed above, the GSE data that are reported to HUD include their purchases of mortgages originated in prior years as well as their purchases of mortgages originated during the current year. The market data reported by HMDA include only mortgages originated in the current year. This means that the GSE-versus-market comparisons are defined somewhat inconsistently for any particular calendar year. Each year, the GSEs have newly-originated loans available for purchase, but they can also purchase loans from a large stock of seasoned (prior-year) loans currently being held in the portfolios of depository lenders. One method for making the purchase-year data more consistent is to aggregate the data over several years, instead of focusing on annual data. This provides a clearer picture of the types of loans that have been originated and are available for purchase by the GSEs. This approach is taken in Tables A.14 and A.15, which are discussed below. Another method for making the GSE and market data consistent is to express the GSE data on an origination-year basis; that approach is taken in Table A.16, which is discussed after presenting the annual results on a purchase-year basis.

a. Longer-Term Performance, 1993–2003 and 1996–2003

Table A.13 summarizes the funding of goals-qualifying mortgages by the GSEs, depositories and the conforming market for the ten-year period between 1993 and 2003. Data are also presented for two important sub-periods: 1993–95 (for showing how much the GSEs have improved their performance since the early-to-mid 1990s); and 1996–2003 (for analyzing their performance since the current definitions of the housing goals were put into effect). Given the importance of the GSEs for expanding homeownership, this section focuses on home purchase mortgages, and the next section will examine first-time homebuyer loans. Section IV below will briefly discuss the GSEs' overall performance, including refinance and home purchase loans. Several points stand out concerning the affordable lending performance of Freddie Mac and Fannie Mae over the two longer-term periods, 1993–2003 and 1996–2003.

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[289] The data in Table A.12 that support Berkovec and Zorn are the 1993–95 special affordable and low-mod data (particularly for Freddie Mac) that show HMDA over reporting percentages by more than a half percentage point. Otherwise, the data in Table A.12, as well as Table A.11, do not present a picture of HMDA's having an upward bias in reporting targeted loans. In fact, the recent years' data suggest a downward bias in HMDA's reporting of targeted loans.

[290] Of course, on an individual year basis, the GSEs' current-year data can differ significantly from the HMDA-reported data on GSE purchases. The other annual data reported in Table A.11 show a mixture of results—in some cases the HMDA percentage is larger than the GSE ''current year'' percentage (*e.g.*, Fannie Mae's special affordable purchases in 2000) while in other cases the HMDA percentage is smaller than the GSE current year percentage (*e.g.*, Freddie Mac's special affordable purchases in recent years). As noted in the text, the differential is typically in the opposite direction to that predicted by Berkovec and Zorn, particularly on the underserved areas category.

[291] Table A.12 also includes aggregates for the more recent period, 1999–2003. The ratios of HMDA-reported-to-GSE-reported averages for this sub-period are similar to those reported for 1996–2003.

[292] Under the origination-year approach, GSE performance for any specific origination year (say year 2000) at the end of a particular GSE purchase year (say year 2003) is subject to change in the future years. Table A.16 (in Section E.9 below) reports that 13.7 percent of year-2000 mortgage originations that Fannie Mae purchased through year 2002 qualify as special affordable; the special affordable share for the market was 16.6 percent in 2000, which indicates that, to date, Fannie Mae has lagged the primary market in funding special affordable mortgages originated during 2000. However, Fannie Mae's special affordable performance could change in the future as Fannie Mae continues to purchase year-2000 originations during 2004 and the following years. Of course, whether Fannie Mae's future purchases result in it ever leading the 2000-year market is not known at this time.

Table A.13

GSE Purchases and Single-Family Lending in Metropolitan Areas
Goal-Qualifying Home Purchase Mortgages, 1993-2003

Borrower and Tract Characteristics	Fannie Mae	Freddie Mac	Ratio Fannie Mae/ Freddie Mac	Depository Total	Depository Portfolio	Conforming Market W/O B&C	Ratio of GSE to Market (W/O B&C) Fannie Mae	Ratio of GSE to Market (W/O B&C) Freddie Mac
Special Affordable								
1993-2003	13.3 %	12.2 %	1.09	15.4 %	16.8 %	15.5 %	0.86	0.79
1993-1995	10.0	8.0	1.25	14.6	17.0	13.7	0.73	0.58
1996-2003	14.1	13.2	1.07	15.6	16.7	15.9	0.89	0.83
1999-2003	15.1	14.7	1.03	16.2	16.8	16.2	0.93	0.91
2000-2003	15.6	15.1	1.03	16.2	16.9	16.0	0.98	0.94
2001-2003	16.2	15.2	1.07	16.0	17.0	15.9	1.02	0.96
Less than Area Median Income								
1993-2003	41.2 %	38.9 %	1.06	42.9 %	43.2 %	43.0 %	0.96	0.90
1993-1995	36.7	32.8	1.12	41.8	44.0	40.8	0.90	0.80
1996-2003	42.2	40.3	1.05	43.1	43.0	43.6	0.97	0.92
1999-2003	43.6	42.6	1.02	44.1	43.1	44.1	0.99	0.97
2000-2003	44.4	42.9	1.03	44.1	43.3	44.1	1.01	0.97
2001-2003	45.2	43.0	1.05	44.1	43.6	44.1	1.02	0.98
Underserved Areas								
1993-2003	23.8 %	21.5 %	1.11	24.9	26.6	25.3 %	0.94	0.85
1993-1995	22.8	19.2	1.19	24.1	26.8	24.0	0.95	0.80
1996-2003	24.0	22.0	1.09	25.1	26.5	25.7	0.93	0.86
1999-2003	24.7	23.1	1.07	25.9	26.9	26.2	0.94	0.88
2000-2003	25.5	23.6	1.08	26.2	27.3	26.4	0.97	0.89
2001-2003	26.0	24.1	1.08	26.1	27.4	26.4	0.98	0.91

Source: The Fannie Mae and Freddie Mac data include information on all their purchases of home loans and are from the loan-level data that they provide to HUD. All mortgages are conventional conforming mortgages. The Depository and Conforming Market data are from HMDA; loans with a loan-to-income ratio greater than six are excluded from the borrower income calculations. "Total Depositories" data are loans originated by HMDA reporters regulated by FDIC, OTS, OCC, FRB, and the National Credit Union Administration; they consist mainly of banks, thrifts, and their subsidieries. The "Depository Portfolio" data refer to new originations that are not sold by banks and thrift institutions and thus are retained in depository portfolios. "Conforming Market W/O B&C" data are the average market percentages after deducting estimates of B&C loans (see text for explanation). Special affordable includes very low-income borrowers and low-income borrowers in low-income census tracts. Data with missing values are excluded.

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Freddie Mac lagged both Fannie Mae and the primary market in funding affordable home loans in metropolitan areas between 1993 and 2003. During that period, 12.2 percent of Freddie Mac's mortgage purchases were for special affordable (mainly very-low-income) borrowers, compared with 13.3 percent of Fannie Mae's purchases, 15.4 percent of loans originated by depositories,[293] and 15.5 percent of loans originated in the conforming market without B&C loans.[294]

Although Freddie Mac consistently improved its performance during the 1990s, a similar pattern characterized the 1996–2003 period. During that period, 40.3 percent of Freddie Mac's purchases were for low- and moderate-income borrowers, compared with 42.2 percent of Fannie Mae's purchases, 43.1 percent of loans originated by depositories, and 43.6 percent of loans originated in the conventional conforming market. Over the same period, 22.0 percent of Freddie Mac's purchases financed properties in underserved neighborhoods, compared with 24.0 percent of Fannie Mae's purchases, 25.1 percent of depository originations, and 25.7 percent of loans originated in the primary market.

Fannie Mae's affordable lending performance was better than Freddie Mac's over the 1993 to 2003 period as well as during the 1996 to 2003 period. However, Fannie Mae lagged behind depositories and the overall market in funding affordable loans during both of these periods (see above paragraph). Between 1996 and 2003, the ''Fannie-Mae-to-market'' ratio was only 0.89 on the special affordable category, obtained by dividing Fannie Mae's performance of 14.1 percent by the market's performance of 15.9 percent. Fannie Mae's market ratio was 0.97 on the low-mod category and 0.93 on the underserved area category. The ''Freddie-Mac-to-market'' ratios for 1996–2003 were lower—0.83 for special affordable, 0.92 for low-mod, and 0.86 for underserved areas.

The above analysis has defined the market to exclude B&C loans, which HUD believes is the appropriate market definition. However, to gauge the sensitivity of the results to how the market is defined, Table A.14 shows the effects on the market percentages for different definitions of the conventional conforming market, such as excluding manufactured housing loans, small loans, and all subprime loans (*i.e.*, the A-minus portion of the subprime market as well as the B&C portion). For example, the average special affordable (underserved area) market percentage for 1996–2003 would fall by about 1.6 (1.2) percentage points if both small loans (less than $15,000) and manufactured loans in metropolitan areas were also dropped from the market definition (see right-hand-side column in Table A.14). Except for Fannie Mae's relative performance on the low-mod category, the above findings with respect to the GSEs' longer-term performance are not much affected by the choice of market definition.

[293] As shown in Table A.13, the depository percentage is higher (16.8 percent) if the analysis is restricted to those newly-originated loans that depositories do not sell (the latter being a proxy for loans held in depositories' portfolios). Note that during the recent, 1999-to-2003 period (also reported in Table A.13), there is less difference between the two depository figures.

[294] Unless stated otherwise, the market in this section is defined as the conventional conforming market without estimated B&C loans.

Table A.14

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas
Goal-Qualifying Home Purchase Mortgages, 1996-2003
Various Market Definitions

			Conventional Conforming Market Originations								
Borrower and Tract Characteristics	Fannie Mae Purchases	Freddie Mac Purchases	Total Market	W/O Mfg Loans Only	W/O Loans Less Than $15K	W/O Mfg and Less Than $15K Loans	W/O Subprime Loans	W/O B&C Loans	W/O B&C and Mfg Loans	W/O B&C and LT $15K Loans	W/O B&C and LT $15K W/O Mfg
Special Affordable											
1996	10.4	8.8	15.0	13.3	14.2	12.8	15.0	15.0	13.3	14.2	12.8
1997	11.7	9.2	15.2	13.4	14.5	12.9	15.0	15.1	13.1	14.4	12.8
1998	13.2	11.5	15.6	13.7	15.0	13.4	15.2	15.4	13.4	14.9	13.1
1999	12.5	12.8	17.3	15.3	16.8	15.0	16.7	17.0	14.9	16.5	14.6
2000	13.3	14.7	16.9	15.4	16.3	15.1	16.2	16.6	14.7	16.0	14.7
2001	14.9	14.4	15.8	14.9	15.5	14.6	15.5	15.6	14.7	15.3	14.4
2002	16.3	15.8	16.2	15.8	15.9	15.5	15.9	16.1	15.6	15.8	15.4
2003	17.1	15.6	15.9	15.6	15.7	15.4	15.9	15.9	15.6	15.7	15.4
1996-2003	14.1	13.2	15.8	14.8	15.6	14.5	15.7	15.9	14.6	15.4	14.3
1999-2003	15.1	14.7	16.4	15.4	16.0	15.1	16.0	16.2	15.2	15.8	14.9
2000-2003	15.6	15.1	16.2	15.4	15.8	15.2	15.9	16.0	15.2	15.7	15.0
2001-2003	16.2	15.2	16.0	15.4	15.7	15.2	15.8	15.9	15.3	15.6	15.1
Less Than Area Median Income											
1996	37.0	33.7	42.2	40.0	41.4	39.4	42.2	42.2	39.9	41.4	39.4
1997	38.3	34.7	42.2	39.8	41.4	39.3	42.0	42.1	39.7	41.4	39.2
1998	40.8	37.6	43.0	40.7	42.5	40.3	42.6	42.8	40.4	42.3	40.0
1999	40.0	40.8	45.2	42.9	44.7	42.5	44.4	44.8	42.4	44.3	42.0
2000	40.8	42.7	44.3	42.6	43.7	42.1	43.5	43.9	42.1	43.3	41.6
2001	42.9	41.3	43.2	42.0	42.7	41.6	42.7	42.9	41.8	42.5	41.3
2002	45.3	44.0	44.8	44.3	44.4	44.0	44.4	44.6	44.1	44.2	43.8
2003	47.0	43.8	44.7	44.4	44.4	44.1	44.5	44.6	44.3	44.3	43.9
1996-2003	42.2	40.3	43.5	42.4	43.3	41.9	43.4	43.6	42.1	43.1	41.7
1999-2003	43.6	42.6	44.3	43.3	44.0	42.9	43.9	44.2	43.0	43.7	42.6
2000-2003	44.4	42.9	44.1	43.4	43.8	43.0	43.8	44.1	43.2	43.6	42.8
2001-2003	45.2	43.0	44.3	43.7	43.9	43.3	43.9	44.1	43.5	43.7	43.1
Underserved Areas											
1996	22.3	19.6	25.0	23.5	24.5	23.1	24.8	24.9	23.4	24.5	23.0
1997	23.0	19.7	25.0	23.5	24.6	23.2	24.6	24.8	23.3	24.4	22.9
1998	22.7	19.8	24.6	23.1	24.3	22.8	23.6	24.2	22.5	23.8	22.3
1999	20.4	20.9	25.8	24.4	25.5	24.1	24.6	25.2	23.7	24.9	23.5
2000	23.4	22.0	27.0	26.0	26.6	25.7	25.4	26.2	25.1	25.9	24.8
2001	24.4	22.3	25.8	25.2	25.5	24.9	24.6	25.2	24.5	24.9	24.2
2002	26.7	25.8	27.1	26.8	26.8	26.6	25.4	26.3	26.0	26.0	25.8
2003	26.8	24.0	28.5	28.3	28.3	28.2	26.6	27.6	27.4	27.4	27.3
1996-2003	24.0	22.0	26.3	25.4	26.0	25.1	25.0	25.7	24.7	25.4	24.5
1999-2003	24.7	23.1	26.9	26.3	26.6	26.0	25.4	26.2	25.5	25.9	25.2
2000-2003	25.5	23.6	27.2	26.7	26.9	26.4	25.5	26.4	25.9	26.1	25.6
2001-2003	26.0	24.1	27.2	26.9	27.0	26.7	25.6	26.4	26.1	26.2	25.9

Source: The Fannie Mae and Freddie Mac percentages for 1996 to 2003 are based on the loan-level mortgage purchase data that they provide to HUD. All mortgages are conventional conforming home purchase mortgages. The Conforming Market data are from HMDA; loans with a loan-to-income-ratio greater than six are excluded from all borrower income calculations. See the text for an explanation of the adjustments for manufactured housing (mfg), subprime, and B&C loans. Special affordable includes very low-income census tracts. Data with missing values are excluded.

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b. Recent Performance, 1999–2003

This and the next subsection focus on the average data for 1999–2003 in Table A.13 and the annual data reported in Table A.14. As explained below, the annual data are useful for showing shifts in the relative positions of Fannie Mae and Freddie Mac that began in 1999, and for highlighting the improvements made by Fannie Mae during 2001–2003 (which were the first three years under HUD's higher goal levels) and by Freddie Mac during 2002. Between 1993 and 1998, Freddie Mac's performance fell below Fannie Mae's, but a sharp improvement in Freddie Mac's performance during 1999 pushed it pass Fannie Mae on all three goals-qualifying categories. In 2000, Fannie Mae improved its underserved areas performance enough to surpass Freddie Mac on that category, while Freddie Mac continued to out-perform Fannie Mae on the borrower-income categories (special affordable and low-mod). By 2002, Fannie Mae had improved its performance enough to surpass Freddie Mac on all three goals-qualifying categories and to lead the special affordable and low-mod markets, while lagging the underserved areas market.

Consider first the average data for 1999–2003 reported in Table A.13. During this recent period, Freddie Mac's average performance was similar to Fannie Mae's performance for the special affordable category. Between 1999 and 2003, 14.7 percent of Freddie Mac's purchases and 15.1 percent Fannie Mae's mortgage purchases consisted of special affordable loans, compared with a market average of 16.2 percent. During this period, Freddie Mac purchased low-mod loans lower than the rate of Fannie Mae—42.6 percent for Freddie Mac, 43.6 percent for Fannie Mae, and 44.1 percent for the market. Freddie Mac (23.1 percent) also purchased underserved area loans at a lower rate than Fannie Mae (24.7 percent) and the primary market (26.2 percent). As these figures indicate, both Fannie Mae and Freddie Mac continued to lag the market during this recent four-year period. The GSEs' market ratios were 0.91–0.93 for special affordable loans and 0.97–0.99 for low-mod loans. Although less than one (where one indicates equal performance with the market), the ''Fannie-Mae-to-market'' ratio (0.94) for the underserved area category was much higher than the ''Freddie-Mac-to-market'' ratio (0.88).

Fannie Mae's performance in 1999 was significantly below its long run trend. Thus, averages for 2000–2003 are also presented in Table A.13, dropping 1999. These data show an increase in Fannie Mae's performance relative to the market. Between 2000 and 2003, special affordable (underserved area) loans accounted for 15.6 percent (25.5 percent) of Fannie Mae's purchases, compared with 16.0 percent (26.4 percent) for the market. During this 2000–2003 period, Fannie Mae slightly led the low-mod market (44.4 percent for Fannie Mae and 44.1 percent for the primary market).

Table A.14 shows the effects on the market percentages for 1999–2003 (as well as 2000–2003) of different definitions of the conventional conforming market. Excluding both small loans and manufactured housing loans (as well as B&C loans) in metropolitan areas would reduce the 1999–2003 market percentage for special affordable loans from 16.2 percent to 14.9 percent, which would place Fannie Mae slightly above the market and Freddie Mac close to the market. Similarly, excluding these loans would reduce the 1999–2003 market percentage for underserved areas from 26.2 percent to 25.2 percent, which would raise Fannie Mae's market ratio from 0.94 to 0.98 and Freddie Mac's, from 0.88 to 0.92. As shown in Table A.14, Fannie Mae is even closer to the market averages if the year 1999 is dropped—over the 2000–2003 period, Fannie Mae's performance on the underserved area category is practically at market levels under the above alternative definition of the market, and its performance on the special affordable and low-mod categories is above market levels.

Finally, Tables A.13 and A.14 report GSE and market data for the even more recent period, 2001–2003, which represents the first three years under the current housing goal targets (put in place by HUD in its Final Rule dated October 30, 2000). These data show that Freddie Mac's average performance during this period was below the market on each of the three housing goals (with market ratios of 0.96 for special affordable, 0.98 for low-mod, and 0.91 for underserved areas and that Fannie Mae's average performance was above the market on the special affordable and low-mod categories (with a market ratio of 1.02 on each category) but below the market on the underserved areas category (with a market ratio of 0.98).

c. GSEs' Performance—Annual Data

Freddie Mac's Annual Performance. As shown by the annual data reported in Table A.15, Freddie Mac significantly improved its purchases of goals-qualifying loans during the 1990s. Its purchases of loans for special affordable borrowers increased from 6.5 percent of its business in 1992 to 9.2 percent in 1997, and then jumped to 14.7 percent in 2000 before falling slightly to 14.4 percent in 2001 and rising again to almost 16 percent in 2002 and 2003. The underserved areas share of Freddie Mac's purchases increased at a more modest rate, rising from 18.6 percent in 1992 to 22.3 percent by 2001; it then jumped to 25.8 percent in 2002 but fell to 24.0 percent in 2003.

Table A.15

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas Goal-Qualifying Home Purchase Mortgages, 1992-2003

Borrower and Tract Characteristics	Fannie Mae	Freddie Mac	Ratio of Fannie Mae to Freddie Mac	Conforming Market (W/O B&C Loans)	Ratio of GSE to Market (W/O B&C) Fannie Mae	Ratio of GSE to Market (W/O B&C) Freddie Mac
Special Affordable						
1992	6.3 %	6.5 %	0.97	10.4 %	0.61	0.63
1993	8.2	7.3	1.12	12.6	0.65	0.58
1994	10.7	8.2	1.30	14.1	0.76	0.58
1995	11.4	8.4	1.36	14.4	0.79	0.58
1996	10.4	8.8	1.18	15.0	0.69	0.59
1997	11.7	9.2	1.27	15.1	0.77	0.61
1998	13.2	11.5	1.15	15.4	0.86	0.75
1999	12.5	12.8	0.98	17.0	0.74	0.75
2000	13.3	14.7	0.90	16.6	0.80	0.89
2001	14.9	14.4	1.03	15.6	0.96	0.92
2002	16.3	15.8	1.03	16.1	1.01	0.98
2003	17.1	15.6	1.10	15.9	1.08	0.98
Less Than Area Median Income						
1992	29.2	28.7	1.02	34.4	0.85	0.83
1993	33.5	31.9	1.05	38.9	0.86	0.82
1994	38.8	33.7	1.15	41.8	0.93	0.81
1995	38.3	32.8	1.17	41.4	0.93	0.79
1996	37.0	33.7	1.10	42.2	0.88	0.80
1997	38.3	34.7	1.10	42.1	0.91	0.82
1998	40.8	37.6	1.09	42.8	0.95	0.88
1999	40.0	40.8	0.98	44.8	0.89	0.91
2000	40.8	42.7	0.96	43.9	0.93	0.97
2001	42.9	41.3	1.04	42.9	1.00	0.96
2002	45.3	44.0	1.03	44.6	1.02	0.99
2003	47.0	43.8	1.07	44.6	1.05	0.98
Underserved Areas						
1992	18.3	18.6	0.98	22.2	0.82	0.84
1993	20.3	18.2	1.12	21.9	0.93	0.83
1994	24.2	19.6	1.23	24.3	1.00	0.81
1995	24.6	19.9	1.24	25.4	0.97	0.78
1996	22.3	19.6	1.14	24.9	0.90	0.79
1997	23.0	19.7	1.17	24.8	0.93	0.79
1998	22.7	19.8	1.15	24.2	0.94	0.82
1999	20.4	20.9	0.98	25.2	0.81	0.83
2000	23.4	22.0	1.06	26.2	0.89	0.84
2001	24.4	22.3	1.09	25.2	0.97	0.88
2002	26.7	25.8	1.03	26.3	1.02	0.98
2003	26.8	24.0	1.12	27.6	0.97	0.87

Source: The Fannie Mae and Freddie Mac percentages for 1993 to 2003 are from the loan-level mortgage purchase data that they provi to HUD; the 1992 GSE data are from HMDA. All mortgages are conventional conforming home purchase mortgages. The Conforming Market data are from HMDA; see text for an explanation of the market adjustment for B&C loans. Loans with a loan-to-income-ratio greater than six are excluded from the borrower income calculations. Special affordable includes very low-income borrowers and low-income borrowers living in low-income census tracts. Data with missing values are excluded.

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With its improved performance, Freddie Mac closed its gap with the market in funding goals-qualifying loans. In 2003, special affordable loans accounted for 15.6 percent of Freddie Mac's purchases and 15.9 percent of loans originated in the conventional conforming market, which produces a ''Freddie-Mac-to-market'' ratio of 0.98 (15.6 divided by 15.9). Table A.15 shows the trend in the ''Freddie-Mac-to-market'' ratio from 1992 to 2003 for each of the goals-qualifying categories. For the special affordable and low-mod categories, Freddie Mac's performance relative to the market remained flat (at approximately 0.60 and 0.80, respectively) through 1997; by 2003, the ''Freddie-Mac-to-market'' ratios had risen to 0.98 for both the special affordable and low-mod categories.

Surprisingly, Freddie Mac did not make much progress during the 1990s closing its gap with the market on the underserved areas category. The ''Freddie-Mac-to-market'' ratio for underserved areas was the same in 2000 (0.84) as it was in 1992 (0.84). While it rose to 0.88 in 2001, that was due more to a decline in the market level than to an improvement in Freddie Mac's performance. However, due to a substantial increase in Freddie Mac's underserved area percentage from 22.3 percent in 2001 to 25.8 percent in 2002, Freddie Mac's performance approached market performance (26.3 percent) during 2002. [295] In the ten years under the housing goals, the year 2002 represented the first time that Freddie Mac's performance in purchasing home loans in underserved areas had ever been within two percentage points of the market's performance.[296] But, as noted above, Freddie Mac's performance on the underserved areas goal fell to 24.0 percent in 2003, leaving it with a ''Freddie Mac-to-Market'' ratio of 0.87.

Fannie Mae's Annual Performance. With respect to purchasing affordable loans, Fannie Mae followed a different path than Freddie Mac. Fannie Mae improved its performance between 1992 and 1998 and made much more progress than Freddie Mac in closing its gap with the market. In fact, by 1998, Fannie Mae's performance was close to that of the primary market for some important components of affordable lending. In 1992, special affordable loans accounted for 6.3 percent of Fannie Mae's purchases and 10.4 percent of all loans originated in the conforming market, giving a ''Fannie Mae-to-market'' ratio of 0.61. By 1998, this ratio had risen to 0.86, as special affordable loans had increased to 13.2 percent of Fannie Mae's purchases and to 15.4 percent of market originations. A similar trend in market ratios can be observed for Fannie Mae on the underserved areas category. In 1992, underserved areas accounted for 18.3 percent of Fannie Mae's purchases and 22.2 percent of market originations, for a ''Fannie Mae-to-market'' ratio of 0.82. By 1998, underserved areas accounted for 22.7 percent of Fannie Mae's purchases and 24.2 percent of market originations, for a higher ''Fannie Mae-to-market'' ratio of 0.94.[297]

The year 1999 saw a shift in the above patterns, with Fannie Mae declining in overall performance while the share of goals-qualifying loans in the market increased. Between 1998 and 1999, the special affordable share of Fannie Mae's business declined from 13.2 percent to 12.5 percent while this type of lending in the market increased from 15.4 percent to 17.0 percent. For this reason, the ''Fannie-Mae-to-market'' ratio for special affordable loans declined sharply from 0.86 in 1998 to 0.74 in 1999. The share of Fannie Mae's purchases in underserved areas also declined, from 22.7 percent in 1998 to 20.4 percent in 1999, which lowered the ''Fannie-Mae-to-market'' ratio from 0.94 to 0.81.

After declining in 1999, Fannie Mae's performance rebounded in 2000, particularly on the underserved areas category. Fannie Mae's underserved areas percentage jumped by three percentage points from 20.4 percent in 1999 to 23.4 percent in 2000. The 2000 figure was similar to its level in 1997 but below Fannie Mae's peak performances of 24–25 percent during 1994 and 1995. Between 1999 and 2000, the ''Fannie-Mae-to-market'' ratio for underserved areas increased from 0.81 to 0.89. Fannie Mae improved its performance on the special affordable goal at a more modest rate. Fannie Mae's special affordable percentage increased by 0.8 percentage points from 12.5 percent in 1999 to 13.3 percent in 2000. The 2000 figure was similar to its previous peak level (13.2 percent) in 1998. The ''Fannie-Mae-to-market'' ratio for special affordable loans increased from 0.74 in 1999 to 0.80 in 2000, with the latter figure remaining below Fannie Mae's peak market ratio (0.86) in 1998.

Fannie Mae continued its improvement in purchasing targeted home loans during 2001, at a time when the conventional conforming market was experiencing a decline in affordable lending; and again in 2002, at a time when the conventional conforming market was increasing enough to return approximately to its year-2000 level. Thus, during the 2000-to-2003 period, Fannie Mae significantly improved its targeted purchasing performance while the primary market originated targeted home loans at about the same rate in 2002 as it did in 2000. As a result, Fannie Mae's performance during 2001 approached the market on the special affordable and underserved area categories and matched the market on the low-mod category. In 2002, Fannie Mae outperformed the market on all three areas categories.

As shown in Table A.15, Fannie Mae increased its special affordable percentage by 1.6 percentage points, from 13.3 percent in 2000 to 14.9 percent in 2001, and then increased it further to 16.3 percent in 2002, the latter being slightly above the market's performance of 16.1 percent. The ''Fannie-Mae-to-market'' ratio for special affordable loans jumped from 0.80 in 2000 to 1.01 in 2002. In 2003, Fannie Mae's special affordable performance jumped to 17.1 percent while the market declined slightly to 15.9 percent, increasing Fannie Mae's market ratio to 1.08.

Between 2000 and 2001, Fannie Mae increased its low-mod percentage from 40.8 percent to 42.9 percent at the same time that the low-mod share of the primary market was falling from 43.9 percent to 42.9 percent, placing Fannie Mae at the market's performance in 2001. During 2002, the low-mod share of Fannie Mae's purchases of home loans increased further to 45.3 percent, placing Fannie Mae 0.7 percentage points above the market performance of 44.6 percent. Between 2002 and 2003 Fannie Mae's performance jumped to 47.0 percent, while the primary market remained at 44.6 percent, giving Fannie Mae a market ratio of 1.05 in 2003.

Fannie Mae increased its underserved area percentage from 23.4 percent in 2000 to 24.2 percent in 2001 while the underserved area share of the primary market was falling from 26.4 percent to 25.2 percent, placing Fannie Mae at less than one percentage point from the market's performance. The ''Fannie-Mae-to-market'' ratio for underserved area loans was 0.97 in 2001. During 2002, the underserved area share of Fannie Mae's purchases of home loans increased further to 26.7 percent, placing Fannie Mae slightly ahead of market performance (26.3 percent). However, between 2002 and 2003, Fannie Mae showed little improvement (rising to 26.8 percent) while the market increased to 27.6 percent, leaving Fannie Mae with a market ratio of 0.97.

As noted earlier, Tables A.13 and A.14 summarize Fannie Mae's average performance over the 2001–2003 period. During these first three years under the current housing goal targets, Fannie Mae led the special affordable market (average performance of 16.2 percent versus 15.9 percent for the market) and the low-mod market (average performance of 45.2 percent versus 44.1 percent for the market) but lagged the underserved areas market (average performance of 26.0 percent versus 26.4 percent for the market). Table A.14 also reports Fannie Mae's 2001–2003 performance under alternative definitions of the primary market. As shown there, the above findings of Fannie Mae's improvement relative to the market during 2001–2003 are further reinforced when lower market percentages are used. For example, Fannie Mae essentially matches the underserved areas market if manufactured housing loans in metropolitan areas (in addition to B&C loans) are excluded from the market definition (a Fannie Mae share of 26.0 percent and a market share of 26.1 percent).

Changes in the ''Fannie-Mae-to-Freddie-Mac'' Performance Ratio. The above discussion documents shifts in the relative performance of Fannie Mae and Freddie Mac

[295] Table A.14 reports annual market percentages that exclude the effects of manufactured housing, small loans, and subprime loans. Freddie Mac's performance is closer to the market average under the alternative market definitions, particularly during 2001 and 2002.

[296] Prior to 2002, Freddie Mac's performance on the underserved areas category had not approached the market even under the alternative market definitions reported in Table A.14.

[297] Freddie Mac, on the other hand, fell further behind the market during this period. In 1992, Freddie Mac had a slightly higher underserved areas percentage (18.6 percent) than Fannie Mae (18.3 percent). However, Freddie Mac's underserved areas percentage had only increased to 19.8 percent by 1998 (versus 22.7 percent for Fannie Mae). Thus, the ''Freddie Mac-to-market'' ratio fell from 0.84 in 1992 to 0.82 in 1998.

over the past few years. To highlight these changing patterns, Table A.15 reports the ratio of Fannie Mae's performance to Freddie Mac's performance for each goals category for the years 1992 to 2003. As shown there, the ''Fannie-Mae-to-Freddie-Mac'' ratio for the special affordable category increased from approximately one in 1992 (indicating equal performance) to over 1.3 during the 1994–97 period, indicating that Fannie Mae clearly out-performed Freddie Mac during this period. Between 1997 and 2000, Freddie Mac substantially increased its special affordable share (from 9.2 percent to 14.7 percent), causing the ''Fannie-Mae-to-Freddie-Mac'' ratio to fall from 1.27 in 1997 to 0.90 in 2000 (indicating Freddie Mac surpassed Fannie Mae). But Fannie Mae's stronger performance during 2001–2003 returned the ratio to above one (1.03 in 2001 and 2002 and 1.10 in 2003), indicating better performance for Fannie Mae (*e.g.*, 17.1 percent in 2002 versus 15.6 percent for Freddie Mac). The ''Fannie-Mae-to-Freddie-Mac'' performance ratio for low-mod loans followed a similar pattern, standing at 1.07 in 2003 (47.0 percent for Fannie Mae versus 43.8 percent for Freddie Mac).

Prior to 2000, the ''Fannie-Mae-to-Freddie-Mac'' ratio for underserved areas had also followed a pattern similar to that outlined above for special affordable loans, but at a lower overall level—rising from about one in 1992 (indicating equal performance) to approximately 1.2 during the 1994–97 period, before dropping to slightly below one (0.98) in 1999. However, Fannie Mae increased its underserved areas percentage from 20.4 percent in 1999 to 24.4 percent in 2001 while Freddie Mac only increased its percentage from 20.9 percent to 22.3 percent. This resulted in the ''Fannie-Mae-to-Freddie-Mac'' ratio rising from 0.98 in 1999 to 1.09 in 2001. But during 2002, Freddie Mac's underserved area percentage jumped by 3.5 percentage points to 25.8 percent, while Fannie Mae's increased at a more modest rate (by 2.3 percentage points) to 26.7 percent, with the result being that the ''Fannie-Mae-to-Freddie-Mac'' ratio for underserved area loans fell from 1.09 in 2001 to 1.03 in 2002. During 2003, Fannie Mae essentially maintained its performance (26.8 percent), while Freddie Mac reduced its performance by 1.8 percentage points to 24.0 percent. This increased the 2003 ''Fannie Mae-to-Freddie Mac'' ratio for underserved areas to 1.12.

To conclude, while Freddie Mac ended the 1990s on a more encouraging note than Fannie Mae, the past four years (2000, 2001, 2002 and 2003) have seen a substantial improvement in Fannie Mae's performance on all three goals-qualifying categories. Fannie Mae ended the 1990s with a decline in affordable lending performance at the same time that Freddie Mac was improving and the share of goals-qualifying loans was increasing in the market. Both GSEs' performance during 2000 was encouraging—Freddie Mac continued to improve, particularly with respect to the borrower-income categories, while Fannie Mae reversed its declining performance, particularly with respect to underserved areas. During 2000, Freddie Mac outperformed Fannie Mae on the special affordable and low-mod categories, while Fannie Mae purchased a higher percentage of loans in underserved areas. During 2001, Fannie Mae continued to improve its performance while Freddie Mac's performance remained about the same and the market's originations of affordable loans declined somewhat. The result was that during 2001 Fannie Mae outperformed Freddie Mac on all three goals-qualifying categories, and even matched the market on the low-mod category. During 2002, both Fannie Mae and Freddie Mac again improved their performance; Fannie Mae continued to outperform Freddie Mac and outperformed the market on all three goals-qualifying categories. While Freddie Mac lagged the market on all three goals-qualifying categories during 2002, it had significantly closed its gap by the end of 2002, particularly on the underserved area category. During 2003, Fannie Mae made significant improvement in the special affordable and low-mod categories, allowing it to lead the primary market. Freddie Mac, on the other hand, simply maintained its 2002 performance in these two categories, which meant it lagged further behind Fannie Mae. On the underserved area category, Fannie Mae maintained its 2002 performance during 2003 while Freddie Mac significantly reduced its performance, leaving both GSEs, but particularly Freddie Mac, behind the primary market on this category.

GSE Purchases of Seasoned Loans. When the GSE data are expressed on a purchase-year basis (as in the above analysis), one factor which affects each GSE's performance concerns their purchases of seasoned (prior-year) loans. As shown in Table A.11, Fannie Mae followed a strategy of purchasing targeted seasoned loans between 1996 and 1998, and again during 2000–2002—all years when Fannie Mae improved its overall affordable lending performance. For example, consider Fannie Mae's underserved area performance of 24.4 percent during 2001, which was helped by its purchases of seasoned mortgages on properties located in underserved neighborhoods. The underserved area percentage for Fannie Mae's purchases of newly-originated (current-year) mortgages was only 23.3 percent in 2001, or 1.9 percentage points below the market average of 25.2 percent. Fannie Mae obtained its higher overall percentage (24.4 percent) by purchasing seasoned loans with a particularly high concentration (28.3 percent) in underserved areas. Similarly, during 2001, the special affordable share of Fannie Mae's purchases of newly-originated mortgages was only 14.2 percent, or 1.4 percentage points below the market average of 15.6 percent. Again, Fannie Mae improved its overall performance by purchasing seasoned loans with a high percentage (18.1 percent) of special affordable loans, enabling Fannie Mae to reduce its gap with the market to 0.7 percentage points—14.9 percent versus 15.6 percent.

As shown in Table A.11, Freddie Mac also followed a strategy of purchasing seasoned special affordable loans mainly after 1999. Prior to 2000, Freddie Mac had not pursued such a strategy, or at least not to the same degree as Fannie Mae. During the 1997–99 period, Freddie Mac's purchases of prior-year mortgages and newly-originated mortgages had similar percentages of special affordable (and low-mod) borrowers. Over time, there have been small differentials between Freddie Mac's prior-year and newly-originated mortgages for the underserved areas category but they have been smaller than the differentials for Fannie Mae (*see* Table A.11).

d. GSEs' Annual Purchases of Home Loans—Origination-Year Basis

Table A.16 reports GSE purchase data for 1996 to 2003 on an origination-year basis. Recall that in this case, mortgages purchased by a GSE in any particular calendar year are allocated to the year that the mortgage was originated, rather than to the year that the mortgage was purchased (as in the above). This approach places the GSE and the market data on a consistent, current-year basis, as explained earlier.

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Table A.16

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas
Goal-Qualifying Home Purchase Mortgages
1996-2003 GSE Data Reported on an Origination-Year Basis[1]

Borrower and Tract Characteristics	Fannie Mae Purchases	Freddie Mac Purchases	Ratio of Fannie Mae to Freddie Mac	Conventional Conforming Market Originations (W/O B&C)	Ratio of GSE to Market (W/O B&C): Fannie Mae	Ratio of GSE to Market (W/O B&C): Freddie Mac
Special Affordable						
1996	11.6	9.4	1.23	15.0	0.77	0.63
1997	11.3	10.0	1.13	15.1	0.75	0.66
1998	12.4	12.2	1.02	15.4	0.81	0.79
1999	13.2	14.0	0.94	17.0	0.78	0.82
2000	13.7	14.0	0.98	16.6	0.83	0.84
2001	14.6	13.5	1.08	15.6	0.94	0.87
2002	16.1	16.0	1.01	16.1	1.00	0.99
2003 [2]	16.8	15.3	1.10	15.9	1.06	0.96
1996-2003	14.0	13.2	1.06	15.9	0.88	0.83
1999-2003	15.0	14.6	1.03	16.2	0.93	0.90
2000-2003	15.4	14.7	1.05	16.0	0.96	0.92
2001-2003	15.9	14.9	1.07	15.9	1.00	0.94
Less Than Area Median Income						
1996	38.5	34.5	1.12	42.2	0.91	0.82
1997	37.9	35.7	1.06	42.1	0.90	0.85
1998	39.7	38.8	1.02	42.8	0.93	0.91
1999	41.0	42.3	0.97	44.8	0.92	0.94
2000	41.4	41.3	1.00	43.9	0.94	0.94
2001	42.5	40.7	1.04	42.9	0.99	0.95
2002	45.5	44.7	1.02	44.6	1.02	1.00
2003 [2]	47.0	43.5	1.08	44.6	1.05	0.98
1996-2003	42.2	40.5	1.04	43.6	0.97	0.93
1999-2003	43.8	42.5	1.03	44.1	0.99	0.96
2000-2003	44.1	42.5	1.04	44.1	1.00	0.96
2001-2003	45.1	42.9	1.05	44.1	1.02	0.97
Underserved Areas						
1996	23.3	19.6	1.19	24.9	0.94	0.79
1997	21.8	19.7	1.11	24.8	0.88	0.79
1998	21.3	20.0	1.07	24.2	0.88	0.83
1999	21.3	21.5	0.99	25.2	0.85	0.85
2000	23.4	22.2	1.05	26.2	0.89	0.85
2001	24.0	22.4	1.07	25.2	0.95	0.89
2002	26.0	25.3	1.03	26.3	0.99	0.96
2003 [2]	26.3	23.4	1.12	27.6	0.95	0.85
1996-2003	23.7	21.9	1.08	25.7	0.92	0.85
1999-2003	24.4	23.0	1.06	26.2	0.93	0.88
2000-2003	25.1	23.4	1.07	26.4	0.95	0.89
2001-2003	25.5	23.7	1.08	26.4	0.97	0.90

Source: See text and notes to previous tables for variable definitions and market methodology.

[1] In this table, GSE data are reported on an "origination-year" basis rather than on a "purchase-year" basis (as are the previous tables on home purchase loans). This means that prior-year loans that the GSEs purchase in a particular calendar year are allocated back to their year of origination. For example, mortgages originated in 2000 but purchased by the GSEs in 2003 would be allocated to 2000 (the year of origination). Thus, the GSE percentages for 2000 represent GSE purchases (in 2000 and in 2001 and in 2002 and in 2003) of mortgages originated in 2000. For this reason, the GSE data in this table are more consistent with the market data. Market percentages are for current-year mortgage originations, based on HMDA data.

[2] The data for 2003 represent only the GSEs' purchases during 2003 of mortgages originated during 2003, as there are not yet any subsequent years in which to report originations. Of course, during 2004 (and during following years), the GSEs will purchase subsequent years in which to report originated in 2003, which would at that time be incorporated into the data for the year 2003.

In general, the comparisons of Freddie Mac's and the market's performance are similar to those discussed in Sections E.9.a-c above, except for some differences on the special affordable category. The ''Freddie Mac to market'' ratios in Table A.16 show that Freddie Mac has improved its performance but has also consistently lagged the primary market in funding mortgages covered by the housing goals.

The ''Fannie Mae to market'' ratios in Table A.16 show that Fannie Mae has improved its performance, has generally outperformed Freddie Mac, and led the market during 2003 on both the special affordable and low-mod goals. Under the origination-year approach, Fannie Mae lagged the market on all three housing goal categories during 2001 and on the underserved area category during 2002. Fannie Mae matched the market in funding special affordable loans during 2002 and led the market in funding low-mod loans. During 2003, Fannie Mae led the primary market on both the special affordable and low-mod categories but lagged the market on the underserved area category. For instance in 2003, low- and moderate-income loans accounted for 47.0 percent of Fannie Mae's purchases and 44.6 percent of the market originations, placing Fannie Mae 2.4 percentage points above the market. On the other hand, underserved areas accounted for 26.3 percent of Fannie Mae's purchases during 2003, which was 1.4 percentage points below market performance.

e. GSEs' Purchases of First-Time Homebuyer Mortgages—1999 to 2001

While not a specific housing goal category, mortgages for first-time homebuyers are an important component of the overall home loan market. Making financing available for first-time homebuyers is one approach for helping young families enter the homeownership market. Therefore, this section briefly compares the GSEs' funding of first-time homebuyer loans with that of primary lenders in the conventional conforming market.

During the past few years, the GSEs have increased their purchases of first-time homebuyer loans. For example, Fannie Mae's annual purchases of first-time homebuyer loans increased from approximately 287,000 in 1999 to 423,485 in 2003.[298] However, since 1999, the first-time homebuyer share of the GSEs' purchases of home loans has remained relatively flat, varying within the 25–28 percent range.[299]

Table A.17a compares the first-time homebuyer share of GSE purchases with corresponding share of home loans originated in the conventional conforming market. Readers are referred to recent work by Bunce and Gardner[300] for the derivation of the estimates of first-time homebuyer market shares reported in Table A.17a. Between 1999 and 2001, first-time homebuyers accounted for 26.5 percent of Fannie Mae's purchases of home loans, 26.5 percent of Freddie Mac's, and 37.6 percent of home loans originated in the conventional conforming market. Thus, both Fannie Mae and Freddie Mac fell substantially short of the primary market in financing first-time homebuyers during this time period. The GSEs' performance was only 70.5 percent of market performance (26.5 percent divided by 37.6 percent).

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[298] These figures include estimates of first-time homebuyer loans for those home purchase loans with a missing first-time homebuyer indicator; the estimates were obtained by multiplying the GSE's first-time homebuyer share (based only on data with a first-time homebuyer indicator) by the number of loans with a missing first-time homebuyer indicator.

[299] The first-time homebuyer share for Fannie Mae was almost 35 percent between 1996 and 1998; it then dropped to 30 percent in 1998 and to 26 percent in 1999. The first-time homebuyer share for Freddie Mac was approximately 29 percent in 1996 and 1997 before dropping to about 25 percent in 1998 and 1999.

[300] *See* Harold L. Bunce and John L. Gardner, ''First-time Homebuyers in the Conventional Conforming Market: The Role of the GSEs'' (unpublished paper), January 2004. An update of this work to include data for 2002 and 2003 shows similar patterns as those reported in the text for 1999–2001. *See* Harold L. Bunce and John L. Gardner, ''First-time Homebuyers in the Conventional Conforming Market: The Role of GSEs: An Update'' (October, 2004).

Table A.17a

First-Time Homebuyer Mortgages as a Share of All Conventional Conforming Home Purchase Mortgages, for GSEs' Purchases and Market Originations, 1999-2001 and 1996-2001 Averages

1999-2001 Averages	Fannie Mae	Freddie Mac	Both GSEs	Conventional Conforming Market
All First-Time Homebuyers	26.5% [1]	26.5%	26.5%	37.6% [3]
African-American and Hispanic First-Time Homebuyers	4.0%	3.4%	3.8%	6.9%
Minority First-Time Homebuyers	6.6% [2]	5.8%	6.2%	10.6% [4]
1996-2001 Averages				
All First-Time Homebuyers	29.3%	26.9%	28.3%	38.4%
African-American and Hispanic First-Time Homebuyers	4.3%	3.1%	3.8%	6.8%
Minority First-Time Homebuyers	6.9%	5.3%	6.3%	10.2%

Notes: These data cover the entire U.S. (i.e., both metropolitan and non-metropolitan areas).
The first-time homebuyer concept for the market analysis is homebuyers who have never owned a home. The concept for the GSEs is purchasers who have not owned a home within the past three years. The market analysis is based on GSE, HMDA, and American Housing Survey data. See Bunce and Gardner (2004) for the methodology for estimating the market first-time homebuyer percentages. Because the percentages for the GSEs include seasoned loans and the market ratios include only current-year mortgage originations, the GSE ratios tend to overstate the GSEs' business shares in each category, compared to mortgage origination activity in a given year.

Interpretations:

[1] First-time homebuyer mortgages were 26.5% of all home purchase mortgages purchased by Fannie Mae in 1999-2001.

[2] Minority first-time homebuyer mortgages were 6.6% of all home purchase mortgages purchased by Fannie Mae in 1999-2001.

[3] First-time homebuyer mortgages were 37.6% of all home purchase mortgage originations in the conventional conforming market during 1999-2001.

[4] Minority first-time homebuyer mortgages were 10.6% of all home purchase mortgage origintions in the conventional conforming market during 1999-2001.

Table A.17a also reports first-time homebuyer shares for African Americans and Hispanics and for all minorities. Between 1999 and 2001, African-American and Hispanic first-time homebuyers accounted for 4.0 percent of Fannie Mae's purchases of home loans, 3.4 percent of Freddie Mac's purchases, and 6.9 percent of home loans originated in the conventional conforming market. for this subgroup, Fannie Mae's performance is 58 percent of market performance, while Freddie Mac's performance is 49 percent of market performance. The group of all minority first-time homebuyers accounted for 6.6 percent of Fannie Mae's purchases of home loans, 5.8 percent of Freddie Mac's purchases, and 10.6 percent of home loans originated in the conventional conforming market. In this case, Fannie Mae's performance is 62 percent of market performance, while Freddie Mac's performance is 55 percent of market performance.

Section E.12 below will continue this examination of first-time homebuyers by presenting market share analysis that estimates the GSEs' overall importance in the funding of first-time homebuyers.

f. Low- and Moderate-Income Subgoal for Home Purchase Loans

The Department is proposing to establishing a subgoal of 45 percent for each GSE's purchases of home purchase loans for low- and moderate-income families in the single-family-owner market of metropolitan areas for 2005, with the subgoal rising to 46 percent for 2006 and 47 percent for 2007 and 2008. If the GSEs meet this subgoal, they will be leading the primary market by approximately one percentage point in 2005 and by three percentage points in 2007–08, based on historical data (see below). This *home purchase* subgoal will encourage the GSEs to expand homeownership opportunities for lower-income homebuyers who are expected to enter the housing market over the next few years. As detailed in Section I, there are four specific reasons for establishing this subgoal: (1) The GSEs have the expertise, resources, and ability to lead the single-family-owner market, which is their ''bread and butter'' business; (2) except for the recent performance of Fannie Mae, the GSEs have historically lagged the primary market for low- and moderate-income loans, not led it; (3) the GSEs can improve their funding of first-time homebuyers and help reduce troublesome disparities in homeownership and access to mortgage credit; and (4) there are ample opportunities for the GSEs to expand their purchases in important and growing market segments such as the market for minority first-time homebuyers. Sections E.9 and G of this appendix provide additional information on opportunities for an enhanced GSE role in the home purchase market and on the ability of the GSEs to lead that market.

As shown in Tables A.13 and A.15, low- and moderate-income families accounted for an average of 44.1 percent of home purchase loans originated in the conventional conforming market of metropolitan areas between 1999 and 2003; the figure is 43.6 percent if the average is computed for the years between 1996 and 2003 or 44.1 percent if the average is computed for the more recent 2001–2003 period. Loans in the B&C portion of the subprime market are excluded from these market averages. To reach the 45-percent subgoal for 2005, Freddie Mac would have to improve its performance by one percentage point over its approximately 44 percent low-mod performance during 2002 and 2003, while Fannie Mae would have to maintain its performance of 45–47 percent over these two years. To reach the 47 percent subgoal in 2007–08, Freddie Mac would have to improve by three percentage points over its 2002–3 performance while Fannie Mae would have to maintain its 2003 performance of 47 percent.

As explained earlier, HUD will be re-benchmarking its median incomes for metropolitan areas and non-metropolitan counties based on 2000 Census median incomes, and will be incorporating the effects of the new OMB metropolitan area definitions. As shown in Table 17b, HUD projected the effects of these two changes on the low- and moderate-income shares of the single-family-owner market for the years 1999–2003. These estimates will be referred to as ''projected data'' while the 1990-based data reported in the various tables will be referred to as ''historical data.'' With the historical data, the average low-mod share of the conventional conforming market (without B&C loans) was 44.2 percent for home purchase loans (weighted average of 1999–2003 percentages in Table A.13); the corresponding average with the projected data was 43.5 percent, a differential of 0.7 percentage points. However, note that in 2003, the projected data for both GSEs and the market exhibit higher low-mod shares than the corresponding historical data. For 2003, the low-mod shares for the projected and historical data are as follows: Fannie Mae (47.5 percent for the projected data versus 47.0 percent for the historical data), Freddie Mac (44.2 percent versus 43.8 percent), and the market (45.6 percent versus 44.6 percent). Thus, based on 2003 experience, it appears that the low-mod share for single-family-owners in the conventional conforming market actually increase based on the re-benchmarking of area median incomes and the new OMB definitions of metropolitan areas. Thus, based on 2003 data, the 47-percent subgoal for 2007 is 2.4 percentage points above the 2003 market.

Table A.17b

Home Purchase Loans

	Fannie Mae		Freddie Mac		Market (W/O B&C)		Market W/O B&C and LT $15,000 Loans	Market W/O B&C, LT $15,000, and Manufactured Housing
Special Affordable	2000-Geography	1990-Geography	2000-Geography	1990-Geography	2000-Geography	1990-Geography	2000-Geography	2000-Geography
1999	12.5%	12.5%	12.8%	12.8%	17.1%	17.0%	16.6%	14.6%
2000	13.4%	13.3%	14.5%	14.7%	16.8%	16.6%	16.2%	14.8%
2001	14.7%	14.9%	13.9%	14.4%	15.4%	15.6%	15.1%	14.1%
2002	15.8%	16.3%	15.1%	15.8%	15.4%	16.1%	15.2%	14.8%
2003	17.7%	17.1%	16.2%	15.6%	16.8%	15.9%	16.5%	16.2%
1999-2003	15.1%	15.1%	14.5%	14.7%	16.3%	16.2%	15.9%	15.0%
2001-2003	16.2%	16.2%	15.0%	15.2%	15.9%	15.9%	15.6%	15.1%
Unweighted Average								
1999-2003	14.8%	14.8%	14.5%	14.7%	16.3%	16.2%	15.9%	14.9%
2001-2003	16.1%	16.1%	15.1%	15.3%	15.9%	15.9%	15.6%	15.0%
2002-2003	16.8%	16.7%	15.7%	15.7%	16.1%	16.0%	15.9%	15.5%
Low-Mod								
1999	39.2%	40.0%	40.0%	40.8%	44.0%	44.8%	43.5%	41.0%
2000	40.1%	40.8%	41.7%	42.7%	43.3%	43.9%	42.6%	40.8%
2001	41.7%	42.9%	39.8%	41.3%	41.6%	42.9%	41.1%	39.9%
2002	43.6%	45.3%	42.1%	44.0%	42.5%	44.6%	42.1%	41.6%
2003	47.5%	47.0%	44.2%	43.8%	45.6%	44.6%	45.2%	44.9%
1999-2003	42.9%	43.6%	41.5%	42.6%	43.5%	44.2%	43.0%	41.8%
2001-2003	44.5%	45.2%	41.9%	43.0%	43.4%	44.1%	43.0%	42.3%
Unweighted Average								
1999-2003	42.4%	43.2%	41.6%	42.5%	43.4%	44.2%	42.9%	41.6%
2001-2003	44.3%	45.1%	42.0%	43.0%	43.2%	44.0%	42.8%	42.1%
2002-2003	45.6%	46.2%	43.2%	43.9%	44.1%	44.6%	437.0%	43.3%
Underserved Areas								
1999	25.3%	20.4%	25.6%	20.9%	30.2%	25.2%	29.8%	28.4%
2000	29.0%	23.4%	27.3%	22.0%	31.7%	26.2%	31.3%	30.3%
2001	29.8%	24.4%	27.3%	22.3%	30.7%	25.2%	30.3%	29.6%
2002	32.3%	26.7%	31.7%	25.8%	31.8%	26.3%	30.9%	30.7%
2003	32.0%	26.8%	29.0%	24.0%	32.5%	27.6%	32.2%	32.1%
1999-2003	30.0%	24.7%	28.3%	23.1%	31.4%	26.2%	31.0%	30.3%
2001-2003	31.4%	26.0%	29.4%	24.1%	31.7%	26.4%	31.2%	30.9%
Unweighted Average								
1999-2003	29.7%	24.3%	28.2%	23.0%	31.4%	26.1%	30.9%	30.2%
2001-2003	31.4%	26.0%	29.3%	24.0%	31.7%	26.4%	31.1%	30.8%
2002-2003	32.2%	26.8%	30.4%	24.9%	32.2%	27.0%	31.6%	31.4%

In terms of projected data, Fannie Mae could meet both the 2005 and 2007 subgoals by maintaining its projected 2003 low-mod performance of 47.5 percent. Freddie Mac's projected low-mod performance for 2003 was 44.2 percent, about 0.4 percentage points above its 2003 performance of 43.8 percent based on historical data. Thus, to reach the 45-percent subgoal for 2005, Freddie Mac would have to increase its 2003 projected performance by 0.8 percentage point, and to reach the 47-percent 2007 subgoal, Freddie Mac would have to increase its performance by 2.8 percentage points over its projected performance of 44.2 percent for 2003.

The subgoal applies only to the GSEs' purchases in metropolitan areas because the HMDA-based market benchmark is only available for metropolitan areas. HMDA data for non-metropolitan areas are not reliable enough to serve as a market benchmark. The Department is also setting home purchase subgoals for the other two goals-qualifying categories, as explained in Appendices B and C.

It should be noted that the findings in subsections 9.a–e above concerning the performance of the GSEs relative to the home purchase market do not change when projected, rather than historical data, are used.

10. GSEs Purchases of Total (Home Purchase and Refinance) Loans

Section E.9 examined the GSEs' acquisitions of home purchase loans, which is appropriate given the importance of the GSEs for expanding homeownership opportunities. To provide a complete picture of the GSEs' mortgage purchases in metropolitan areas, Tables A.18, A.19, A.20, and A.21 report the GSEs' purchases of all single-family-owner mortgages, including both home purchase loans and refinance loans.[301]

[301] The GSE total (home purchase and refinance) data in Tables A.18–A.20 are presented on a purchase-year basis; Table A.21 presents similar data on an origination-year basis.

Table A.18

GSE Purchases and Single-Family Lending in Metropolitan Areas
Goal-Qualifying Home Purchase and Refinance Mortgages, 1993-2003

Borrower and Tract Characteristics	Fannie Mae	Freddie Mac	Ratio of Fannie Mae to Freddie Mac	Conventional Conforming Market: Total	Conventional Conforming Market: (W/O B&C Loans)	Ratio of GSE to Market (W/O B&C): Fannie Mae	Ratio of GSE to Market (W/O B&C): Freddie Mac
Special Affordable							
1993-2003	12.6 %	11.6 %	1.09	14.8 %	14.3 %	0.88	0.81
1993-1995	8.3	7.2	1.15	11.6	11.4	0.73	0.63
1996-2003	13.4	12.5	1.07	15.4	14.8	0.91	0.84
1999-2003	14.0	13.2	1.06	15.6	15.0	0.93	0.88
2000-2003	14.2	13.2	1.08	15.2	14.7	0.97	0.90
2001-2003	14.2	12.8	1.11	14.7	14.2	1.00	0.90
Less than Area Median Income							
1993-2003	39.6 %	37.4 %	1.06	41.9 %	41.2 %	0.96	0.91
1993-1995	33.0	31.0	1.06	37.0	36.8	0.90	0.84
1996-2003	40.9	38.8	1.05	42.8	42.1	0.97	0.92
1999-2003	41.8	39.7	1.05	43.3	42.5	0.98	0.93
2000-2003	42.2	39.5	1.07	42.8	42.1	1.00	0.94
2001-2003	42.2	38.9	1.08	42.2	41.6	1.01	0.94
Underserved Areas							
1993-2003	23.1 %	21.6 %	1.07	25.7 %	24.8 %	0.93	0.87
1993-1995	21.9	20.3	1.08	23.5	23.2	0.94	0.88
1996-2003	23.4	21.8	1.07	26.1	25.2	0.93	0.87
1999-2003	23.8	22.1	1.08	26.2	25.2	0.94	0.88
2000-2003	24.0	21.9	1.10	25.9	25.0	0.96	0.88
2001-2003	23.9	21.6	1.11	25.3	24.5	0.98	0.88

Source: The Fannie Mae and Freddie Mac data include information on all their single-family-owner mortgage purchases from the loan-level data that they provide to HUD. All mortgages are conventional conforming mortgages. "Conventional Conforming Market" data are from HMDA; loans with a loan-to-income ratio greater than six are excluded from the borrower income calculations. The numbers in the "W/O B&C Loans" column are the average market percentages after deducting B&C loans from the adjacent "Total" market column (see text for explanation). Special affordable includes very low-income borrowers and low-income borrowers in low-income census tracts. Data with missing values are excluded.

Table A.19

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas
Goal-Qualifying Home Purchase and Refinance Mortgages, 1996-2003
Various Market Definitions

			Conventional Conforming Market Originations						
Borrower and Tract Characteristics	Fannie Mae Purchases	Freddie Mac Purchases	Total Market	W/O Mfg and Less Than $15K Loans	W/O Subprime Loans	W/O B&C Loans	W/O B&C and Mfg Loans	W/O B&C and LT $15K Loans	W/O B&C, Mfg, and LT $15K
Special Affordable									
1996	10.5 %	9.4 %	15.3 %	13.7 %	14.4 %	14.8 %	13.7 %	14.1 %	13.2 %
1997	11.5 %	10.1 %	16.2 %	14.7 %	14.6 %	15.5 %	14.4 %	14.8 %	13.8 %
1998	11.1 %	11.0 %	14.2 %	13.2 %	12.6 %	13.5 %	12.7 %	13.1 %	12.4 %
1999	12.4 %	13.4 %	18.3 %	17.0 %	16.1 %	17.3 %	16.2 %	16.9 %	15.9 %
2000	14.5 %	16.1 %	19.1 %	17.8 %	16.9 %	18.1 %	17.1 %	17.5 %	16.7 %
2001	13.9 %	13.3 %	15.0 %	14.4 %	13.9 %	14.5 %	14.1 %	14.2 %	13.9 %
2002	14.3 %	13.6 %	14.9 %	14.6 %	13.9 %	14.4 %	14.3 %	14.3 %	14.1 %
2003	14.3 %	12.0 %	14.3 %	14.1 %	13.6 %	14.0 %	13.9 %	13.9 %	13.8 %
1996-2003	13.4 %	12.5 %	15.4 %	14.7 %	14.2 %	14.8 %	14.3 %	14.5 %	14.1 %
1999-2003	14.0 %	13.2 %	15.6 %	15.0 %	14.4 %	15.0 %	14.6 %	14.8 %	14.4 %
2000-2003	14.2 %	13.2 %	15.2 %	14.7 %	14.1 %	14.7 %	14.4 %	14.5 %	14.2 %
2001-2003	14.2 %	12.8 %	14.7 %	14.3 %	13.8 %	14.2 %	14.1 %	14.1 %	13.9 %
Less Than Area Median Income									
1996	37.0 %	34.8 %	42.4 %	40.4 %	41.4 %	41.9 %	40.5 %	41.2 %	39.8 %
1997	38.0 %	36.1 %	43.4 %	41.4 %	41.5 %	42.5 %	41.0 %	41.8 %	40.4 %
1998	37.4 %	36.7 %	40.9 %	39.6 %	38.9 %	39.9 %	38.9 %	39.5 %	38.6 %
1999	39.3 %	41.2 %	46.3 %	44.7 %	43.7 %	45.1 %	43.8 %	44.6 %	43.4 %
2000	42.3 %	44.3 %	47.0 %	45.5 %	44.5 %	45.9 %	44.7 %	45.2 %	44.2 %
2001	41.7 %	40.2 %	42.3 %	41.6 %	40.9 %	41.6 %	41.2 %	41.3 %	40.9 %
2002	42.2 %	40.1 %	42.7 %	42.3 %	41.3 %	42.0 %	41.9 %	41.8 %	41.7 %
2003	42.3 %	37.2 %	41.7 %	41.5 %	40.6 %	41.2 %	41.1 %	41.0 %	40.9 %
1996-2003	40.9 %	38.8 %	42.8 %	42.0 %	41.3 %	42.6 %	41.5 %	41.7 %	41.1 %
1999-2003	41.8 %	39.7 %	43.3 %	42.5 %	41.6 %	42.5 %	42.0 %	42.1 %	41.7 %
2000-2003	42.2 %	39.5 %	42.8 %	42.2 %	41.3 %	42.1 %	41.7 %	41.8 %	41.5 %
2001-2003	42.2 %	38.9 %	42.2 %	41.8 %	40.9 %	41.6 %	41.4 %	41.3 %	41.1 %
Underserved Areas									
1996	22.9 %	20.7 %	26.7 %	25.3 %	25.3 %	26.0 %	25.0 %	25.6 %	24.6 %
1997	23.3 %	21.4 %	27.7 %	26.4 %	25.3 %	26.6 %	25.6 %	26.2 %	25.2 %
1998	21.1 %	20.8 %	24.8 %	23.9 %	22.4 %	23.7 %	23.0 %	23.4 %	22.7 %
1999	21.7 %	23.3 %	28.2 %	27.3 %	25.4 %	26.9 %	26.1 %	26.7 %	25.9 %
2000	25.2 %	24.6 %	30.1 %	29.2 %	27.1 %	28.7 %	28.0 %	28.4 %	27.7 %
2001	24.2 %	22.5 %	25.7 %	25.3 %	23.9 %	24.9 %	24.6 %	24.7 %	24.4 %
2002	24.0 %	22.9 %	25.0 %	24.8 %	23.2 %	24.2 %	24.1 %	24.1 %	24.0 %
2003	23.7 %	20.1 %	25.3 %	25.2 %	23.7 %	24.5 %	24.5 %	24.5 %	24.4 %
1996-2003	23.4 %	21.8 %	26.1 %	25.6 %	24.1 %	25.2 %	24.7 %	25.0 %	24.6 %
1999-2003	23.8 %	22.1 %	26.2 %	25.8 %	24.2 %	25.2 %	24.9 %	25.1 %	24.8 %
2000-2003	24.0 %	21.9 %	25.9 %	25.6 %	24.0 %	25.0 %	24.8 %	24.8 %	24.6 %
2001-2003	23.9 %	21.6 %	25.3 %	25.1 %	23.6 %	24.5 %	24.4 %	24.4 %	24.3 %

Source: The Fannie Mae and Freddie Mac percentages are based on the loan-level data that they provide to HUD. All mortgages are conventional conforming home purchase and refinance mortgages. The Conventional Conforming Market data are from HMDA; loans with a loan-to-income-ratio greater than six are excluded from all borrower income calculations. See the text for an explanation of the adjustments for manufactured housing (Mfg), subprime, and B&C loans. Special affordable includes very low-income borrowers and low-income borrowers living in low-income census tracts. Data with missing values are excluded.

Table A.20

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas Goal-Qualifying Home Purchase and Refinance Mortgages, 1997-2003

Borrower and Tract Characteristics	Fannie Mae Purchases	Freddie Mac Purchases	Ratio of Fannie Mae to Freddie Mac	Conventional Conforming Market Originations (W/O B&C)	Ratio of GSE to Market (W/O B&C) Fannie Mae	Ratio of GSE to Market (W/O B&C) Freddie Mac
Special Affordable Borrower						
1997	11.5 %	10.1 %	1.14	15.5 %	0.74	0.65
1998	11.1 %	11.0 %	1.01	13.5 %	0.82	0.81
1999	12.4 %	13.4 %	0.93	17.3 %	0.72	0.77
2000	14.5 %	16.1 %	0.90	18.1 %	0.80	0.89
2001	13.9 %	13.3 %	1.05	14.5 %	0.96	0.92
2002	14.3 %	13.6 %	1.05	14.4 %	0.99	0.94
2003	14.3 %	12.0 %	1.19	14.0 %	1.02	0.86
Less Than Area Median Income Borrower						
1997	38.0 %	36.1 %	1.05	42.5 %	0.89	0.85
1998	37.4 %	36.7 %	1.02	39.9 %	0.94	0.92
1999	39.3 %	41.2 %	0.95	45.1 %	0.87	0.91
2000	42.3 %	44.3 %	0.95	45.9 %	0.92	0.97
2001	41.7 %	40.2 %	1.04	41.6 %	1.00	0.97
2002	42.2 %	40.1 %	1.05	42.0 %	1.00	0.95
2003	42.3 %	37.2 %	1.14	41.2 %	1.03	0.90
Underserved Areas						
1997	23.3 %	21.4 %	1.09	26.6 %	0.88	0.80
1998	21.1 %	20.8 %	1.01	23.7 %	0.89	0.88
1999	21.7 %	23.3 %	0.93	26.9 %	0.81	0.87
2000	25.2 %	24.6 %	1.02	28.7 %	0.88	0.86
2001	24.2 %	22.5 %	1.08	24.9 %	0.97	0.90
2002	24.0 %	22.9 %	1.05	24.2 %	0.99	0.95
2003	23.7 %	20.1 %	1.18	24.5 %	0.97	0.82

Source: Special affordable includes very low-income borrowers plus low-income borrowers living in low-income census tracts. Very low-income (low-income) is defined as income less than or equal to 60 (80) percent of area median income. An underserved area is defined as a census tract with median income at or below 90 percent of the area median income; or a census tract with median income at or below 120 percent of the median income areas and a minority population of 30 percent or greater. Data with missing values are excluded.

Table A.21

Annual Trends in GSE Purchases and Single-Family Lending in Metropolitan Areas Goal-Qualifying Home Purchase and Refinanace Mortgages 1996-2003 GSE Data Reported on an Origination-Year Basis[1]

Borrower and Tract Characteristics	Fannie Mae Purchases	Freddie Mac Purchases	Ratio of Fannie Mae to Freddie Mac	Conventional Conforming Market Originations (W/O B&C)	Ratio of GSE to Market (W/O B&C)	
					Fannie Mae	Freddie Mac
Special Affordable						
1996	11.4 %	9.9 %	1.15	14.8 %	0.77	0.67
1997	11.1 %	10.7 %	1.04	15.5 %	0.72	0.69
1998	10.7 %	11.4 %	0.94	13.5 %	0.79	0.84
1999	13.4 %	15.0 %	0.89	17.3 %	0.77	0.87
2000	14.8 %	16.0 %	0.93	18.1 %	0.82	0.88
2001	13.5 %	12.7 %	1.06	14.5 %	0.93	0.88
2002	14.2 %	13.4 %	1.06	14.4 %	0.99	0.93
2003 [2]	14.4 %	11.9 %	1.21	14.0 %	1.03	0.85
1996-2003	13.4 %	12.6 %	1.06	14.8 %	0.91	0.85
1999-2003	14.1 %	13.2 %	1.07	15.0 %	0.94	0.88
2000-2003	14.2 %	12.9 %	1.10	14.7 %	0.97	0.88
2001-2003	14.1 %	12.6 %	1.12	14.2 %	0.99	0.89
Less Than Area Median Income						
1996	38.2 %	35.6 %	1.07	41.9 %	0.91	0.85
1997	37.6 %	36.7 %	1.02	42.5 %	0.88	0.86
1998	36.7 %	37.2 %	0.99	39.9 %	0.92	0.93
1999	41.0 %	43.3 %	0.95	45.1 %	0.91	0.96
2000	42.8 %	43.8 %	0.98	45.9 %	0.93	0.95
2001	41.1 %	39.3 %	1.05	41.6 %	0.99	0.94
2002	42.3 %	40.1 %	1.05	42.0 %	1.01	0.95
2003 [2]	42.6 %	37.0 %	1.15	41.2 %	1.03	0.90
1996-2003	41.0 %	38.9 %	1.05	42.6 %	0.96	0.91
1999-2003	42.1 %	39.7 %	1.06	42.5 %	0.99	0.93
2000-2003	42.2 %	39.2 %	1.08	42.1 %	1.00	0.93
2001-2003	42.1 %	38.7 %	1.09	41.6 %	1.01	0.93
Underserved Areas						
1996	23.7 %	21.0 %	1.13	26.0 %	0.91	0.81
1997	22.2 %	21.5 %	1.03	26.6 %	0.83	0.81
1998	20.5 %	21.1 %	0.97	23.7 %	0.86	0.89
1999	22.8 %	24.3 %	0.94	26.9 %	0.85	0.90
2000	25.5 %	25.2 %	1.01	28.7 %	0.89	0.88
2001	23.7 %	22.4 %	1.06	24.9 %	0.95	0.90
2002	23.6 %	22.2 %	1.06	24.2 %	0.98	0.92
2003 [2]	23.7 %	19.9 %	1.19	24.5 %	0.97	0.81
1996-2003	23.2 %	22.8 %	1.02	25.2 %	0.92	0.90
1999-2003	23.7 %	22.0 %	1.08	25.2 %	0.94	0.87
2000-2003	23.8 %	21.7 %	1.10	25.0 %	0.95	0.87
2001-2003	23.7 %	21.3 %	1.11	24.5 %	0.97	0.87

Source: See text and notes to previous tables for variable definitions and market methodology.

[1] In this table, GSE data are reported on an "origination-year" basis rather than on a "purchase-year" basis (as are the previous tables on home purchase and refinance loans). This means that prior-year loans that the GSEs purchase in a particular calendar year are allocated back to their year of origination. For example, mortgages originated in 2000 but purchased by the GSEs in 2003 would be allocated to 2000 (the year of origination). Thus, the GSE percentages for 2000 represent GSE purchases (in 2000 and in 2001 and in 2002 and in 2003) of mortgages originated in 2000. For this reason, the GSE data in this table are more consistent with the market data. Market percentages are for current-year mortgage originations, based on HMDA data.

[2] The data for 2003 represent only the GSEs' purchases during 2003 of mortgages originated during 2003, as there are not yet any subsequent years in which to report originations to report. Of course, during 2004 (and during following years), the GSEs will purchase prior-year loans originated in 2003, which would at that time be incorporated into the data for the year 2003.

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Table A.18 provides a long-run perspective on the GSEs' overall performance. Between 1993 and 2003, as well as during the 1996–2003 period, the GSEs' performance was 81–91 percent of market performance for the special affordable category, 91–97 percent of market performance for the low-mod category, and 87–93 percent of market performance for the underserved areas category. For example, between 1996 and 2003, underserved areas accounted for 23.4 percent of Fannie Mae's purchases and 21.8 percent of Freddie Mac's purchases, compared with 25.2 percent for the conventional conforming market (without B&C loans). Similarly, for special affordable loans, both GSEs lagged the market during the 1996–2003 period—Fannie Mae and Freddie Mac averaged approximately 13.0 percent while the market was over two percentage points higher at 14.8 percent.

Similar to the patterns discussed for home purchase loans, Fannie Mae has tended to outperform Freddie Mac. This can be seen by examining the various ''Fannie-Mae-to-Freddie-Mac'' ratios in Table A.18, which are all equal to or greater than one. Over the recent 1999–2003 period, Fannie Mae and Freddie Mac continued to lag the overall market on all three goals-qualifying categories. Special affordable (underserved area) loans averaged 14.0 (23.8) percent of Fannie Mae's purchases, 13.2 (22.1) percent of Freddie Mac's purchases, and 15.0 (25.2) percent of market originations. For Fannie Mae, the market ratio was 0.93 for special affordable loans, 0.98 for low-mod loans, and 0.94 for underserved area loans. As with home purchase loans, dropping the year 1999 and characterizing recent performance by the 2000–2003 period improves the performance of both GSEs relative to the market, but particularly Fannie Mae. Over the 2000–2003 period, the ''Fannie-Mae-to-market'' ratio was 0.97 for special affordable loans, 1.00 for low-mod loans, and 0.96 for underserved area loans. Over the last three years (2001–2003), the ''Fannie-Mae-to-market'' ratios are even higher—1.00 for special affordable loans, 1.01 for low-mod loans, and 0.98 for underserved area loans. In other words, during the first three years under the current housing goal targets, Fannie Mae matched the special affordable market, led the low-mod market, and lagged the underserved areas market.

The above analysis has defined the market to exclude B&C loans. Table A.19 shows the effects on the market percentages of different definitions of the conventional conforming market. For example, the average 1999–2003 market share for special affordable (underserved areas) loans would fall to 14.4 (24.8) percent if small loans and manufactured housing loans in metropolitan areas were excluded from the market definition along with B&C loans. In this case, the market ratio for Fannie Mae (Freddie Mac) would be was 0.97 (0.92) for special affordable loans, 1.00 (0.95) for low-mod loans, and 0.96 (0.89) for underserved area loans.

Shifts in performance occurred during 2001–2003, the first three years under HUD's higher housing goal targets. Table A.20 shows that both GSEs improved their overall performance between 1999 and 2000, but they each fell back a little during the heavy refinancing year of 2001. But the primary market (without B&C loans) experienced a much larger decline in affordable lending during the refinancing wave than did either of the GSEs. Fannie Mae stood out in 2001 because of its particularly small decline in affordable lending. Between 2000 and 2001, Fannie Mae's special affordable lending fell by only 0.6 percentage points while Freddie Mac's fell by 2.8 percentage points and the market's fell by 3.6 percentage points. The corresponding percentage point declines for the underserved areas category were 1.0 for Fannie Mae, 1.9 for Freddie Mac, and 3.8 for the market. By the end of 2001, Fannie Mae led Freddie Mac in all three goals-qualifying categories, and had erased its gap with the low-mod market, but continued to lag the market on the special affordable and underserved areas categories.

During the refinancing wave of 2002, Fannie Mae improved slightly on the special affordable and low-mod categories and declined slightly on the underserved area category. Freddie Mac showed slight improvement on the special affordable and underserved area categories and remained about the same on the low-mod category. The result of these changes can be seen by considering the market ratios in Table A.20. In 2002, special affordable loans accounted for 14.3 percent of Fannie Mae's purchases and 14.4 percent of loans originated in the non-B&C portion of the conventional conforming market, yielding a ''Fannie-Mae-to-market'' ratio of 0.99. Since Fannie Mae's market ratio for the special affordable category stood at 0.80 in 2000, Fannie Mae substantially closed its gap with the market during 2001 and 2002. During this period, Fannie Mae also mostly eliminated its market gap for the other two goals-qualifying categories. In 2002, underserved area loans accounted for 24.0 percent of Fannie Mae's purchases and 24.2 percent of loans originated in the non-B&C portion of the conventional conforming market, yielding a ''Fannie-Mae-to-market'' ratio of 0.99, or approximately one. During 2002, low-mod loans accounted for 42.2 percent of Fannie Mae's purchases and 42.0 percent of loans originated in the market, yielding a ''Fannie-Mae-to-market'' ratio of 1.00 (also note that Fannie Mae slightly outperformed the low-mod market during 2001). Thus, during 2002, Fannie Mae essentially matched the market on each of the three goals-qualifying categories.

In 2003, Fannie Mae's continued to improve its performance on the special affordable and low-mod categories. In 2003, special affordable loans accounted for 14.3 percent of Fannie Mae's purchases and 14.0 percent of loans originated in the market, yielding a ''Fannie-Mae-to-market'' ratio of 1.02. During that year, low-mod loans accounted for 42.3 percent of Fannie Mae's purchases and 41.2 percent of total (home purchase and refinance) loans originated in the market, yielding a ''Fannie-Mae-to-market'' ratio of 1.03. On the underserved areas category, Fannie Mae continued to lag behind the market (a 23.7 percent share for Fannie Mae and a 24.5 percent share for the market).

Freddie Mac significantly lagged the single-family (home purchase and refinance loans combined) market during 2001–2003. In 2003, the ''Freddie-Mac-to-market'' ratios were 0.86 for special affordable loans, 0.98 for low-mod loans, and 0.82 for underserved area loans.

Subprime Loans. Table A.14 in Section E.9 showed that the goals-qualifying shares of the home purchase market did not change much when originations by subprime lenders are excluded from the analysis; the reason is that subprime lenders operate primarily in the refinance market. Therefore, in this section's analysis of the total market (including refinance loans), one would expect the treatment of subprime lenders to significantly affect the market estimates and, indeed, this is the case. For the year 2001, excluding subprime loans reduced the goal-qualifying shares of the total market as follows: special affordable, from 15.0 to 13.9 percent; low-mod, from 42.3 to 40.9 percent; and underserved areas, from 25.7 to 23.9 percent. (See Table A.19.) Similar declines take place in 2002 and 2003.

As explained earlier, the comparisons in this appendix have defined the market to exclude the B&C portion of the subprime market. Industry observers estimate that A-minus loans account for about two-thirds of all subprime loans while the more risky B&C loans account for the remaining one-third. As explained earlier, this analysis reduces the goal-qualifying percentages from the HMDA data by half the differentials between (a) the market (unadjusted) and (b) the market without the specialized subprime lenders identified by Scheessele. As shown in Table A.19, accounting for B&C loans in this manner reduces the year 2001 HMDA-reported goal-qualifying shares of the total (home purchase and refinance) conforming market as follows: special affordable, from 15.0 to 14.5 percent; low-mod, from 42.3 to 41.6 percent; and underserved areas, from 25.7 to 24.9 percent. Obviously, the GSEs' performance relative to the market will depend on which market definition is used (much as it did with the earlier examples of excluding manufactured housing loans in metropolitan areas from the market definition). For example, defining the conventional conforming market to exclude subprime loans, rather than only B&C loans, would increase Fannie Mae's 2001 special affordable (underserved area) market ratio from 0.96 to 1.00 (0.97 to 1.01). Similarly, it would increase Freddie Mac's special affordable (underserved area) market ratio from 0.92 to 0.96 (0.90 to 0.94). For the broader-defined low-mod category, redefining the 2001 market to exclude subprime loans, rather than only B&C loans, would increase Fannie Mae's (Freddie Mac's) market ratio from 1.00 to 1.02 (0.97 to 0.98).

Table A.21 reports GSE purchase data for total (home purchase and refinance) loans on an origination-year basis. The ''Freddie Mac-to-market'' ratios in Table A.21 show that Freddie Mac has lagged the primary market in funding mortgages covered by the housing goals. The ''Fannie Mae-to-market'' ratios in Table A.21 show that Fannie Mae has always lagged the primary market in funding home purchase and refinance mortgages for properties in underserved areas but, in 2002 and 2003, led the low-mod market, and in 2003 led the special affordable market.

11. GSE Mortgage Purchases in Individual Metropolitan Areas

While the above analyses, as well as earlier studies, concentrate on national-level data, it is also instructive to compare the GSEs' purchases of mortgages in individual metropolitan areas (MSAs). In this section, the GSEs' purchases of single-family owner-occupied home purchase loans are compared to the market in individual MSAs. There are three steps. *First,* goals-qualifying percentages for conventional conforming mortgage originations (without B&C loans) are computed for each year and for each MSA, based on HMDA data. *Second,* corresponding goals-qualifying percentages are computed for each GSE's purchases for each year and for each MSA. These two sets of percentages are the same as those used in the aggregate analysis discussed in the above sections. *Third,* the ''GSE-to-market'' ratio is then calculated by dividing each GSE percentage by the corresponding market percentage. For example, if it is calculated that one of the GSEs' purchases of low- and moderate-income loans in a particular MSA is 40 percent of their overall purchases in that MSA, while 44 percent of all home loans (excluding B&C loans) in that MSA qualify as low-mod, then the GSE-to-market ratio is 40/44 (or 0.91). The goals-qualifying ratios for Fannie Mae and Freddie Mac can be compared for each MSA in a similar manner.

Tables A.22, A.23, and A.24 summarize the performance of the GSEs within MSAs for 2001, 2002 and 2003 originations of home purchase loans. A GSE's performance is determined to be lagging the market if the ratio of the GSE housing goal loan purchases to their overall purchases is less than 99 percent of that same ratio for the market. (The analysis was conducted where the ''lag'' determination is made at 98 percent instead of 99 percent and the results showed little change.) In the example given in the above paragraph, that GSE would be considered lagging the market. Tables A.22 (2001), A.23 (2002) and A.24 (2003) report the number of MSAs in which each GSE under-performs the market with respect to each of the three housing goal categories. The following points can be made from this data:

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Table A.22

Analysis of GSEs' Purchases Across MSAs by Housing Goal Category 2001 Originations

	Underserved Areas		Low-Mod Income		Special Affordable	
Number of MSAs Analyzed	331	100.0%	331	100.0%	331	100.0%
Fannie Mae Lags the Market	264	79.8%	194	58.6%	251	75.8%
Freddie Mac Lags the Market	261	78.9%	274	82.8%	279	84.3%
Fannie Mae Lags Freddie Mac	162	48.9%	76	23.0%	109	32.9%
Freddie Mac Lags Fannie Mae	147	44.4%	228	68.9%	211	63.7%

Source: Fannie Mae and Freddie Mac data are from the loan-level data they provide to HUD. The market data are conforming originations as reported in HMDA data.

Notes: The GSE loans in this analysis include all single-family owner-occupied conventional conforming home purchase mortgages in metropolitan areas (as defined by OMB in 2001) purchased by the GSEs between 2001 and 2003 for loans originated in 2001. Loans with a loan-to-income ratio greater than six are excluded from Low-Mod Income and Special Affordable analyses.

In general, a GSE is determined to lag the market (or lag the other GSE) for a category (i.e., underserved area, low- and moderate-income, or special affordable defined as very low-income occupant or low-income occupant in low-income area) if the ratio of the share of category loans in that GSE's purchases to the share of category loans in market originations (or in the other GSE's purchases) is less than 99%. Exceptions to this procedure are as follows:

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, that MSA is excluded from the analysis for that category.

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by one of the GSEs, that GSE is counted as not lagging the market in that MSA for that category regardless of the calculated ratio.

If, for loans in a category in an MSA, there are 5 or more loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, then neither GSE is counted as lagging the other GSE in that MSA for that category regardless of the calculated ratio.

Table A.23

Analysis of GSEs' Purchases Across MSAs by Housing Goal Category 2002 Originations

	Underserved Areas		Low-Mod Income		Special Affordable	
Number of MSAs Analyzed	331	100.0%	331	100.0%	331	100.0%
Fannie Mae Lags the Market	236	71.3%	126	38.1%	173	52.3%
Freddie Mac Lags the Market	168	50.8%	224	67.7%	222	67.1%
Fannie Mae Lags Freddie Mac	204	61.6%	74	22.4%	120	36.3%
Freddie Mac Lags Fannie Mae	113	34.1%	235	71.0%	193	58.3%

Source: Fannie Mae and Freddie Mac data are from the loan-level data they provide to HUD. The market data are conforming originations as reported in HMDA data.

Notes: The GSE loans in this analysis include all single-family owner-occupied conventional conforming home purchase mortgages in metropolitan areas (as defined by OMB in 2002) purchased by the GSEs between 2002 and 2003 for loans originated in 2002. Loans with a loan-to-income ratio greater than six are excluded from Low-Mod Income and Special Affordable analyses.

In general, a GSE is determined to lag the market (or lag the other GSE) for a category (i.e., underserved area, low- and moderate-income, or special affordable defined as very low-income occupant or low-income occupant in low-income area) if the ratio of the share of category loans in that GSE's purchases to the share of category loans in market originations (or in the other GSE's purchases) is less than 99%. Exceptions to this procedure are as follows:

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, that MSA is excluded from the analysis for that category.

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by one of the GSEs, that GSE is counted as not lagging the market in that MSA for that category regardless of the calculated ratio.

If, for loans in a category in an MSA, there are 5 or more loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, then neither GSE is counted as lagging the other GSE in that MSA for that category regardless of the calculated ratio.

Table A.24

Analysis of GSEs' Purchases Across MSAs by Housing Goal Category 2003 Originations

	Underserved Areas		Low-Mod Income		Special Affordable	
Number of MSAs Analyzed	331	100.0%	331	100.0%	331	100.0%
Fannie Mae Lags the Market	243	73.4%	51	15.4%	121	36.6%
Freddie Mac Lags the Market	222	67.1%	255	77.0%	234	70.7%
Fannie Mae Lags Freddie Mac	148	44.7%	39	11.8%	73	22.1%
Freddie Mac Lags Fannie Mae	165	49.8%	281	84.9%	243	73.4%

Source: Fannie Mae and Freddie Mac data are from the loan-level data they provide to HUD. The market data are conforming originations as reported in HMDA data.

Notes: The GSE loans in this analysis include all single-family owner-occupied conventional conforming home purchase mortgages in metropolitan areas (as defined by OMB in 2002) purchased by the GSEs in 2003 for loans originated in 2003. Loans with a loan-to-income ratio greater than six are excluded from Low-Mod Income and Special Affordable analyses.

In general, a GSE is determined to lag the market (or lag the other GSE) for a category (i.e., underserved area, low- and moderate-income, or special affordable defined as very low-income occupant or low-income occupant in low-income area) if the ratio of the share of category loans in that GSE's purchases to the share of category loans in market originations (or in the other GSE's purchases) is less than 99%. Exceptions to this procedure are as follows:

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, that MSA is excluded from the analysis for that category.

If, for loans in a category in an MSA, there are fewer than 5 loans reported in the HMDA data and fewer than 5 loans purchased by one of the GSEs, that GSE is counted as not lagging the market in that MSA for that category regardless of the calculated ratio.

If, for loans in a category in an MSA, there are 5 or more loans reported in the HMDA data and fewer than 5 loans purchased by each of the GSEs, then neither GSE is counted as lagging the other GSE in that MSA for that category regardless of the calculated ratio.

Fannie Mae's improvement between 2001 and 2003 shows up in these tables. In 2001, Fannie Mae lagged the market in 264 (80 percent) of the 331 MSAs in the purchase of underserved area loans; this number decreased to 236 (71 percent) MSAs in 2002 and to 243 (73 percent) MSAs in 2003. Fannie Mae's improvement was even greater for special affordable and low-mod loans; in the latter case, Fannie Mae lagged the market in 51 (15 percent) MSAs in 2003, compared with 194 (59 percent) MSAs in 2001.

Freddie Mac's improvement between 2001 and 2003 was greater for underserved area loans. In 2001, Freddie Mac lagged the market in 261 (79 percent) of the 331 MSAs in the purchase of underserved area loans; this number decreased to 168 (51 percent) MSAs in 2002 before rising to 222 (67 percent) MSAs in 2003. Freddie Mac's made less improvement on the special affordable and low-mod categories; in the former case, Freddie Mac lagged the market in 234 (71 percent) MSAs in 2003, compared with 279 (84 percent) MSAs in 2001.

12. GSE Market Shares: Home Purchase and First-Time Homebuyer Loans

This section examines the role that the GSEs have played in the overall affordable lending market for home loans. There are two differences from the above analyses in Sections E.9 and E.10. *The first difference* is that this section focuses on ''market share'' percentages rather than ''distribution of business'' percentages. A ''market share'' percentage measures the share of loans with a particular borrower or neighborhood characteristic that is funded by a particular market sector (such as FHA or the GSEs). In other words, a ''market share'' percentage measures a sector's share of all home loans originated for a particular targeted group. The ''market share'' of a sector depends not only on the degree to which that sector concentrates its business on a targeted group (*i.e.*, its ''distribution of business'' percentage) but also on the size, or overall mortgage volume, of the sector. If an industry sector has a large ''market share'' for a targeted group, then that sector is making an important contribution to meeting the credit needs of the group. Both ''distribution of business'' and ''market share'' data are important for evaluating the GSEs' performance. In fact, given the large size of the GSEs, one would expect that a ''market share'' analysis would highlight their importance to the affordable lending market.

The *second difference* is that this section also examines the role of the GSEs in the total market for home loans, as well as in the conventional conforming market. Such an approach provides a useful context for commenting on the contribution of Fannie Mae and Freddie Mac to overall affordable lending, particularly given evidence that conventional lenders have done a relatively poor job providing credit access to disadvantaged families, which renders the conventional market a poor benchmark for evaluating GSE performance. The analysis of first-time homebuyers conducts the market share analysis in terms of both the total market (Section E.12.b) and the conventional conforming market (Section E.12.c).

While the GSEs have accounted for a large share of the overall market for home purchase loans, they have accounted for a very small share of the market for important groups such as minority first-time homebuyers. But as this section documents, the GSEs have been increasing their share of the low-income and minority market, which provides an optimistic note on which to go forward.

Section E.12.a uses HMDA and GSE data to estimate the GSEs' share of home loans originated for low-income and minority borrowers and their neighborhoods. Sections E.12.b and E.12.c summarize recent research on the role of the GSEs in the first-time homebuyer market. Section E.12.d examines the downpayment characteristics of home loans purchased by the GSEs, a potentially important determinant of the GSEs' ability to reach first-time homebuyers.

a. GSEs' Share of Home Purchase Lending

Table A.25 reports market share estimates derived by combining HMDA market data with GSE and FHA loan-level data. To understand these estimates, consider the GSE market share percentage of 46 percent for ''All Home Purchase Loans'' at the bottom of the first column in the table. That market share percentage is interpreted as follows:

It is estimated that home loans acquired by Fannie Mae and Freddie Mac during the years, 1999 to 2003, totaled 46 percent of all home loans originated in metropolitan areas during that period.

It should be noted that ''all home loans'' refers to all government (FHA and VA) loans plus all conventional loans less than the conforming loan limit; in other words, only ''jumbo loans'' are excluded from this analysis.[302] The analysis is restricted to metropolitan areas because HMDA data (the source of the market estimates) are reliable only for metropolitan areas. B&C originations are included in the market data, since the purpose here is to gauge the GSEs' role in the overall mortgage market. As discussed in Section E.9, excluding B&C loans, or even all subprime loans, would not materially affect this analysis of the home loan market since subprime loans are mainly for refinance purposes. The analysis below frequently combines purchases by Fannie Mae and Freddie Mac since previous sections have already compared their performance relative to each other.

[302] Following the purchase-year approach used in Sections E.9 and E.10, the GSE purchase data include their acquisitions of ''prior-year'' as well as ''current-year'' mortgages, while the market data include only newly-originated (or ''current year'') mortgages.

Table A.25

FHA-Insured Loans and GSE Purchases as Shares of Home Purchase Mortgages Originated in Metropolitan Areas During 1999-2003

	GSE Purchases			FHA-Insured
	1999-2003	2002	2003	1999-2003
Low-Income Borrowers	38%	43%	43%	24% [1]
African-American and Hispanic Borrowers	29.8	34	33.8	29.0
Low-Income Tracts	35.5	43.5	39.5	23.5
High Minority Tracts	38.3	41.5	41.1	21.5
Underserved Areas[2]	37.1	44.0	40.2	22.4
All Home Purchase Loans	45.6	49.3	46.6	16.0

Source: 1999, 2000, 2001, 2002 and 2003 GSE, FHA, and HMDA data.

Notes: The FHA figures refer to percentages of all newly-mortgaged home purchase mortgage loans (except jumbo loans above the conforming loan limit) in metropolitan areas that were FHA insured during 1999, 2000, 2001, 2002 and 2003; the FHA data are from FHA. The GSE figures are defined differently-- they include GSE purchases in metropolitan areas during 1999 to 2003, of 1999-2003 conventional conforming mortgage originations and originations prior to 1999. (About 28% of the GSEs' 1999 purchases were mortgages originated prior to 1999.) Borrower and race percentages are calculated by reallocating missing FHA, GSE, and conventional market data for these variables. FHA had fewer cases with missing data than the GSEs and the market. As with the FHA data, the GSE purchases are expressed as a percentage of the total market in metropolitan areas. In this table, the "total market" includes all (government and conventional) home purchase mortgages originated in metropolitan areas during 1999, 2000, 2001, 2002 and 2003 that were below each year's conforming loan limit. The market data assume that HMDA covers 85 percent of the metropolitan mortgage market. A lower coverage assumption would increase the market totals and thus reduce the GSE and FHA market shares.

[1] That is, it is estimated that FHA insured 24 percent of all home purchase loans (below the conforming loan limit) that were originated for low-income borrowers in metropolitan areas during 1999-2003.

[2] Metropolitan census tracts with (1) median income less than or equal to 90 percent of AMI or (2) minority concentration greater than or equal to 30 percent and tract median income less than or equal to 120 percent of AMI.

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The GSE market share percentage for ''Low-Income Borrowers'' at the top of the first column of Table A.25 has a similar interpretation:

It is estimated that home loans for low-income borrowers acquired by Fannie Mae and Freddie Mac between 1999 and 2003 totaled 38 percent of all home loans originated for low-income borrowers in metropolitan areas.

According to the data in Table A.25, the GSEs account for a major portion of the market for targeted groups. For example, purchases by Fannie Mae and Freddie Mac represented 38 percent of the low-income-borrower market and 36–38 percent of the markets in low-income, high-minority, and underserved census tracts. Thus, access to credit in these historically underserved markets depends importantly on the purchase activities of Fannie Mae and Freddie Mac. However, the data in Table A.25 show that the GSEs' role in low-income and minority markets is significantly less than their role in the overall home loan market. Fannie Mae and Freddie Mac accounted for 46 percent of all home loans but only 37 percent of the loans financing properties in underserved neighborhoods. Their market share was even lower for loans to African-American and Hispanic borrowers—30 percent, or 16 percentage points less than the GSEs' overall market share of 46 percent.

An encouraging finding is that the GSEs have increased their presence in the affordable lending market during 2002 and 2003, when they accounted for 40–44 percent of the loans financing properties in low-income, high-minority, and underserved neighborhoods and for 34 percent of loans for African-American and Hispanic borrowers. These market share figures for the GSEs are generally higher than their performance during the two earlier years, 2000 and 2001.

To provide additional perspective, Table A.25 also reports market share estimates for FHA.[303] During the 1999–2003 period, FHA's overall market share was less than half of the GSEs' market share, as FHA insured only 16 percent of all home mortgages originated in metropolitan areas. However, FHA's shares of the underserved segments of the market were much higher than its overall market share. For instance, between 1999 and 2003, FHA insured 24 percent of all mortgages originated in low-income census tracts, even though it insured only 16 percent of all home loans. FHA's share of the market was particularly high for African-American and Hispanic borrowers, as FHA insured 29 percent of all home loans originated for these borrowers between 1999 and 2003—a figure only one percentage point higher than the GSEs' share of 30 percent.[304] Thus, during the 1999–2003 period, FHA's overall market share (16.0 percent) was about one-third of the GSEs' market share (45.6 percent), but its share of the market for loans to African-Americans and Hispanics was almost equal to the GSEs' share of that market.

The data for the two recent years (2002 and 2003) indicate a larger market role for Fannie Mae and Freddie Mac relative to FHA. While the GSEs continued to have a much larger share of the overall market than FHA (47–49 percent for the GSEs versus 11–14 percent for FHA), their share of home loans for African-Americans and Hispanics jumped to 34 percent during 2002 and 2003, which was higher than the percentage share for FHA (17–25 percent). The differentials in market share between FHA and the GSEs on the other affordable lending categories listed in Table A.25 were also higher in 2002 and 2003 than in earlier years.

b. The GSEs' Share of the Total First-Time Homebuyer Market

This section summarizes two recent analyses of mortgage lending to first-time homebuyers; these two studies examine the total mortgage market, including both government and conventional loans originated throughout the U.S. (*i.e.*, in both metropolitan areas and non-metropolitan areas). Section E.12.c will summarize a third study of first-time homebuyers that focuses on the conventional conforming market. All three studies are market share studies that examine the GSEs' role in the first-time homebuyer market.

First, a study by Bunce concluded that the GSEs have played a particularly small role in funding minority first-time homebuyers.[305] Because HMDA does not require lenders to report information on first-time homebuyers, Bunce used data from the American Housing Survey to estimate the number of first-time homebuyers in the market. Using American Housing Survey data on home purchases from 1997 to 1999, Bunce estimated that the GSEs' share of the market for first-time African-American and Hispanic homebuyers was only 10–11 percent, or less than one-third of their share (36 percent) of all home purchases during that period. FHA's share of this market was 36 percent, or twice its share (18 percent) of all home purchases.[306] These data highlight the small role that the GSEs have played in the important market for minority first-time homebuyers.

Bunce, Neal and Vandenbroucke (BNV) recently updated through 2001 the study by Bunce. In addition, BNV developed an improved methodology that combined industry, HMDA and AHS data to estimate the number of first-time homebuyers (by race and ethnicity) in the mortgage market during the years 1996 to 2001.[307] BNV's analysis includes the total mortgage market, that is, the government, conventional conforming, and jumbo sectors of the mortgage market.

Table A.26 presents the key market shares estimated by BNV for the GSEs and FHA. The first figure (40.7) in Table A.26 is interpreted as follows: purchases of home loans by Fannie Mae and Freddie Mac totaled 40.7 percent of all home loans financed between 1996 and 2001. Going down the first column shows that the GSEs' share of the first-time homebuyer market was 24.5 percent during the 1996-to-2001—a market share significantly lower than their overall market share of 40.7 percent.

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[303] As explained in Section E.7, the GSEs' affordable lending performance is evaluated relative to the conventional conforming market, as required by Congress in the 1992 GSE Act that established the housing goals. However, it is insightful to examine their overall role in the mortgage market and to contrast them with other major sectors of the market such as FHA. There is no intention here to imply that the GSEs should purchase the same types of loans that FHA insures.

[304] As explained in the notes to Table A.25, HMDA data are the source of the market figures. It is assumed that HMDA data cover 85 percent of all mortgage originations in metropolitan areas. If HMDA data covered higher (lower) percentages of market loans, then the market shares for both the GSEs and FHA would be lower (higher).

[305] See Harold L. Bunce, *The GSEs' Funding of Affordable Loans: A 2000 Update*, Housing Finance Working Paper No. HF–013, Office of Policy Development and Research, HUD, April 2002.

[306] Bunce explains numerous assumptions and caveats related to combining American Housing Survey data on homebuyers with FHA and GSE data on mortgages. For example, the American Housing Survey (AHS) data used by Bunce included both financed home purchases and homes purchased with cash. If only financed home purchases were used, the market shares of both FHA and the GSEs would have been slightly higher (although the various patterns would have remained the same). The AHS defines first-time homebuyers as buyers who have never owned a home, while FHA and the GSEs define a first-time homebuyer more expansively as buyers who have not owned a home in the past three years. If it were possible to re-define the FHA and GSE data to be consistent with the AHS data, the FHA and GSE first-time homebuyer shares would be lower (to an unknown degree). For additional caveats with the AHS data, also see David A. Vandenbroucke, Sue G. Neal, and Harold L. Bunce, ''First-Time Homebuyers: Trends from the American Housing Survey'', November 2001, *U.S. Housing Market Condition*, a quarterly publication of the Office of Policy Development and Research at HUD. In some years, home purchases as measured by the AHS declined while home purchases as measured by other data sources (*e.g.*, HMDA) increased. In addition, the AHS home purchase data for separate minority groups (*e.g.*, African-Americans, Hispanics) sometimes exhibited shifts inconsistent with other sources.

[307] BNV's methodology for estimating first-time borrowers consists of three steps: (1) estimate the total number of home purchase loans originated during a particular year using a mortgage market model that they develop; (2) disaggregate the home purchase loans in step (1) into racial and ethnic groups using HMDA data for metropolitan areas; and (3) for each racial and ethnic group in step (2), estimate the number of first-time homebuyers using mortgage and first-time homebuyer information from the American Housing Survey.

Table A.26

Role of GSEs in First-Time Homebuyer Market
Market Shares, 1996-2001

GSE (FHA) Share of Market for:	1996-2001		1999-2001				2001			
	GSEs	FHA	Fannie Mae	Freddie Mac	GSEs	FHA	Fannie Mae	Freddie Mac	GSEs	FHA
1. All Homebuyers	40.7 % [1]	16.6 %	23.8 %	17.7 %	41.5 %	16.4 %	28.1 %	20.6 %	48.7 %	16.7 %
a. African-American and Hispanic	23.8	32.0	14.9	9.4	24.3	31.2	19.6	11.1	30.7	30.9
b. Minority	28.9	27.5	18.1	11.3	29.4	26.8	22.9	13.6	36.5	25.5
2. First-Time Homebuyers	24.5	30.9	14.4	9.7	24.1	31.2	16.9	11.6	28.5	30.7
a. African-American and Hispanic	14.0	44.8	9.1	5.2	14.3	46.5	12.6	7.1	19.7	46.1
b. Minority	17.3 [2]	38.7	10.8	6.4	17.2	39.1	14.7	8.5	23.2	37.8

Source: Bunce, Neal, and Vandenbroucke (2003). GSE home purchase loan data are from the loan-level data they report to HUD. The GSE first-time homebuyer data are from the census tract file of the Public Use Data Base. Missing race and ethnicity data are re-allocated based on the race and ethnicity percentage distribution of the non-missing data. FHA home purchase loan data are from FHA. The market includes all home purchase mortgages (government, conventional conforming, and jumbo loans); see text for explanations of mortgage market estimates for all homebuyers and first-time homebuyers.

[1] Interpreted as follows: Purchases of home loans by the GSEs between 1996 and 2001 totaled 40.7 percent of all home loans originated during that period.

[2] Interpreted as follows: Purchases of home loans by the GSEs between 1996 and 2001 totaled 17.3 percent of all home loans originated for minority first-time homebuyers during that period.

FHA's greater focus on first-time homebuyers is also reflected in the market share data reported in Table A.26. While FHA insured only 16.6 percent of all home loans originated between 1996 and 2001, it insured 30.9 percent of all first-time-homebuyer loans during that period. The GSEs, on the other hand, accounted for a larger share (40.7 percent) of the overall home purchase market but a smaller share (24.5 percent) of the first-time homebuyer market.

Table A.26 also reports home purchase and first-time homebuyer information for minorities. During the more recent 1999-to-2001 period, the GSEs' loan purchases represented 41.5 percent of all home mortgages but only 24.3 percent of home loans for African-American and Hispanic families, and just 14.3 percent of home loans for African-American and Hispanic first-time homebuyers. During this period, the GSEs' role in the market for first-time African-American and Hispanic homebuyers was only one-third of their role in the overall home loan market (14.3 percent versus 41.5 percent).

FHA, on the other hand, accounted for a much larger share of the minority first-time homebuyer market than it did of the overall homebuyer market. Between 1999 and 2001, FHA insured 46.5 percent of all loans for African-American and Hispanic first-time homebuyers—a market share that was almost three times its overall market share of 16.4 percent.[308] While FHA's market share was two-fifths of the GSEs' share of the overall home purchase market (16.4 percent versus 41.5 percent), FHA's market share was over three times the GSEs' share of the market for first-time African-American and Hispanic homebuyers (46.5 percent versus 14.3 percent). This finding that the GSEs have played a relatively minor role in the first-time minority market is similar to the conclusion reached by the Fed researchers (see below) and Bunce (2002) that the GSEs have provided little credit support to this underserved borrower group.

The results reported in Table A.26 for the year 2001 suggest some optimism concerning the GSEs' role in the first-time homebuyer market. As explained in earlier sections, both GSEs, but particularly Fannie Mae, improved their affordable lending performance during 2001, at a time when the overall market's performance was slightly declining. This improvement is reflected in the higher first-time market shares for the GSEs during the year 2001, compared with the two previous years, 1999 and 2000 (not reported). The GSEs' share of the market for first-time African-American and Hispanic homebuyers jumped from about 11–12 percent during 1999 and 2000 to 19.7 percent in 2001. Fannie Mae's share of this market almost doubled during this period, rising from 7.0 percent in 1999 to 12.6 percent in 2001. Thus, while the GSEs continue to play a relatively small role in the minority first-time homebuyer market, during 2001 they improved their performance in this area.[309]

c. The GSEs' Share of the Conventional Conforming, First-time Homebuyer Market

Bunce and Gardner (2004) recently conducted an analysis of first-time homebuyers for the conventional conforming market. The Bunce and Gardner analysis used a similar methodology to the study by Bunce, Neal, and Vandenbroucke of first-time homebuyers in the total mortgage market. Bunce and Gardner restricted their analysis to the funding of first-time homebuyers in the conventional conforming market, which is the market where Fannie Mae and Freddie Mac operate. Their market share results are summarized in Table A.27.

[308] See Bunce, Neal, and Vandenbroucke, *op. cit.,* for comparisons of various estimates of the market shares for FHA and the GSEs using different data bases and estimation methods. One can compare (a) the 1999–2001 market shares for FHA and the conventional conforming market in metropolitan areas calculated using the same methodology as Table A.25 *with* (b) the 1999–2001 market share estimates reported in Table A.25 for the entire mortgage market (including jumbo loans and covering non-metropolitan areas as well as metropolitan areas). The results are strikingly consistent. For the 1999-to-2001 period, the FHA share of the overall (African American and Hispanic) home loan market is estimated to be 19.0 percent (35.8 percent) under (a) versus 16.4 percent (31.2 percent) under (b). Lower percentage shares are expected for (b) because (b) includes jumbo loans. For the same period, the GSE share of the overall (African American and Hispanic) home loan market is estimated to be 46.0 percent (25–28 percent) under (a) versus 41.5 percent (24.3 percent) under (b).

[309] For other analyses of the GSEs' market role, see the following study by economists at the Federal Reserve Board: Glenn B. Canner, Wayne Passmore, and Brian J. Surette, ''Distribution of Credit Risk among Providers of Mortgages to Lower-Income and Minority Homebuyers'' in *Federal Reserve Bulletin*, 82(12): 1077–1102, December, 1996. This study considered several characteristics of the GSEs' loan purchases (such as amount of downpayment) and concluded that the GSEs have played a minimal role in providing credit support for underserved borrowers.

Table A.27

GSEs' Share of Conventional Conforming Loans for All Homebuyers and for First-Time Homebuyers, 1996-2001

	1999-2001	1996-2001
All Homebuyers		
Fannie Mae Purchases	32.5%	32.4%
Freddie Mac Purchases	24.0%	23.2%
Both GSEs' Purchases	56.6%	55.5%
African-American and Hispanic Homebuyers		
Fannie Mae Purchases	27.7%	28.3%
Freddie Mac Purchases	17.5%	16.7%
Both GSEs' Purchases	45.2%	45.0%
Minority Homebuyers		
Fannie Mae Purchases	31.4%	31.9%
Freddie Mac Purchases	19.5%	18.8%
Both GSEs' Purchases	50.9%	50.7%
All First-Time Homebuyers		
Fannie Mae Purchases	22.9%	24.7%
Freddie Mac Purchases	16.9%	16.3%
Both GSEs' Purchases	39.8%	41.0%
African-American and Hispanic First-Time Homebuyers		
Fannie Mae Purchases	19.0%	20.2%
Freddie Mac Purchases	11.9%	10.4%
Both GSEs' Purchases	30.9%	30.6%
Minority First-Time Homebuyers		
Fannie Mae Purchases	20.1%	22.1%
Freddie Mac Purchases	13.0%	12.1%
Both GSEs' Purchases	33.1%	34.2%

Source: These data cover the entire U.S. market (i.e., both metropolitan and non-metropolitan areas). See Bunce and Gardner (2004) for derivation of the conventional conforming market estimates and the source of the GSE data. Missing race and ethnicity data for first-time homebuyers are re-allocated based on the race and ethnicity percentage distribution of the non-missing data.

Between 1999 and 2001, the GSEs' purchases accounted for 56.6 percent of all home loans originated in the conventional conforming market of both metropolitan areas and non-metropolitan areas. In other words, Fannie Mae and Freddie Mac funded almost three out of every five homebuyers entering the conventional conforming market between 1999 and 2001. Their purchases of first-time homebuyer loans, on the other hand, accounted for only 39.8 percent of all first-time homebuyer loans originated in that market. Thus, while the GSEs funded approximately two out of every five first-time homebuyers entering the conventional conforming market, their market share (39.8 percent) for first-time homebuyers was only 70 percent of their market share (56.6 percent) for all homebuyers.

As shown in Table A.27, the GSEs have funded an even lower share of the minority first-time homebuyer market. Between 1999 and 2001, the GSEs purchases of African-American and Hispanic first-time homebuyer loans represented 30.9 percent of the conventional conforming market for these loans. Thus, while the GSEs have accounted for 56.6 percent of all home loans in the conventional conforming market, they have accounted for only 30.9 percent of loans originated in that market for African-American and Hispanic first-time homebuyers.

The market share data in Table A.27 show some slight differences between the Freddie Mac and Fannie Mae in serving minority first-time homebuyers. During the 1999-to-2001 period, Freddie Mac's share (11.9 percent) of the African-American and Hispanic first-time homebuyer market was only one-half of its share (24.0 percent) of the home loan market. On the other hand, Fannie Mae's share (19.0 percent) of the African-American and Hispanic first-time homebuyer market was almost 60 percent of its share (32.5 percent) of the home loan market. Thus, while Fannie Mae performance in serving minority first-time homebuyers has been poor, it has been better than Freddie Mac's. This difference in performance between Fannie Mae and Freddie Mac was also seen in the portfolio percentages reported earlier in Table A.17a. Loans for African-American and Hispanic first-time homebuyers accounted for 6.9 percent of Fannie Mae's purchases of home loans between 1999 and 2001, a figure higher than Freddie Mac percentage of 5.3 percent. Loans for African-American and Hispanic first-time homebuyers accounted for 10.2 percent of all home loans originated in the conventional conforming market.

d. Downpayments on Loans Purchased by the GSEs

The level of downpayment can be an important obstacle to young families seeking their first homes. Examining the downpayment characteristics of the mortgages purchased by the GSEs might help explain why they have played a rather limited role in the first-time homebuyer market

Table A.28 reports the loan-to-value (LTV) distribution of home purchase mortgages acquired by the GSEs between 1997 and 2003. In Table A.29, LTV data are provided for the GSEs' purchases of home loans that qualify for the three housing goals—special affordable, low-mod, and underserved areas. Three points stand out.

Table A.28

Loan-to-Value Distribution for GSE Home Purchase Loans, 1997-2003

	Fannie Mae													
	Number of Mortgages							Percent of Total						
LTV Ratio	1997	1998	1999	2000	2001	2002	2003	1997	1998	1999	2000	2001	2002	2003
0-80%	534,685	681,789	629,425	711,178	799,610	886,024	1,045,266	56.6%	52.3%	53.3%	59.0%	53.1%	53.0%	54.6%
80-90%	173,786	239,579	189,471	189,021	209,715	215,442	196,674	18.4%	18.4%	16.0%	15.7%	13.9%	12.9%	10.3%
90-95%	188,041	289,999	253,117	219,891	275,973	275,782	264,935	19.9%	22.2%	21.4%	18.3%	18.3%	16.5%	13.8%
95% and Over	31,539	53,491	48,337	51,855	107,287	128,295	220,127	3.3%	4.1%	4.1%	4.3%	7.1%	7.7%	11.5%
Missing	17,130	39,941	60,810	32,847	111,867	167,692	188,045	1.8%	3.1%	5.1%	2.7%	7.4%	10.0%	9.8%
Total Loans	945,181	1,304,799	1,181,160	1,204,792	1,504,452	1,673,235	1,915,047	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Exhibit: Over 90%	219,580	343,490	301,454	271,746	383,260	404,077	485,062	23.2%	26.3%	25.5%	22.6%	25.5%	24.1%	25.3%

	Freddie Mac													
	Number of Mortgages							Percent of Total						
LTV Ratio	1997	1998	1999	2000	2001	2002	2003	1997	1998	1999	2000	2001	2002	2003
0-80%	339,526	456,975	474,156	525,455	617,456	640,394	556,722	56.3%	53.8%	55.9%	56.9%	59.8%	59.1%	59.5%
80-90%	110,745	154,230	137,117	136,968	140,365	152,777	105,393	18.4%	18.2%	16.2%	14.8%	13.6%	14.1%	11.3%
90-95%	146,293	204,804	184,971	181,996	213,864	185,064	142,910	24.2%	24.1%	21.8%	19.7%	20.7%	17.1%	15.3%
95% and Over	6,456	22,203	43,601	54,543	44,232	51,890	43,787	1.1%	2.6%	5.1%	5.9%	4.3%	4.8%	4.7%
Missing	364	11,107	8,767	24,134	16,768	53,790	87,435	0.1%	1.3%	1.0%	2.6%	1.6%	5.0%	9.3%
Total Loans	603,384	849,319	848,612	923,096	1,032,685	1,083,915	936,247	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Exhibit: Over 90%	152,749	227,007	228,572	236,539	258,096	236,954	186,697	25.3%	26.7%	26.9%	25.6%	25.0%	21.9%	19.9%

Note: Includes home purchase mortgages financing owner-occupied one-unit properties.

Table A.29

Loan-to-Value Characteristics of GSEs' Home Purchase Mortgages Meeting the Housing Goals, 1999-2003

Fannie Mae															
LTV Ratio	Special Affordable					Low-Mod					Underserved Areas				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
0-80%	54.1%	55.2%	49.3%	48.1%	44.7%	53.5%	56.3%	50.6%	51.3%	50.5%	47.8%	53.1%	48.0%	46.8%	49.8%
80-90%	13.8%	13.2%	12.5%	13.8%	9.6%	16.4%	15.7%	14.2%	14.3%	10.7%	17.9%	17.4%	15.2%	16.7%	11.6%
90-95%	19.1%	18.0%	17.7%	18.5%	14.4%	22.9%	20.4%	20.4%	19.7%	15.9%	27.3%	22.2%	22.8%	22.5%	16.9%
95% and Over	7.2%	8.4%	15.7%	14.7%	22.9%	7.1%	7.4%	12.7%	12.7%	19.3%	6.9%	7.2%	12.4%	12.4%	18.9%
Missing	5.9%	5.1%	4.9%	4.9%	8.4%	0.2%	0.2%	2.1%	2.1%	3.6%	0.1%	0.1%	1.6%	1.6%	2.8%
Total Loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Exhibit: Over 90%	26.2%	26.5%	33.4%	33.2%	37.3%	29.9%	27.8%	33.1%	32.3%	35.2%	34.2%	29.4%	35.2%	34.9%	35.9%

Freddie Mac															
LTV Ratio	Special Affordable					Low-Mod					Underserved Areas				
	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
0-80%	59.0%	52.4%	53.1%	55.9%	54.3%	55.0%	52.4%	54.5%	56.1%	55.9%	50.1%	47.4%	48.7%	53.3%	53.6%
80-90%	13.9%	12.3%	12.4%	15.5%	12.6%	15.6%	14.1%	13.6%	15.0%	12.4%	17.6%	15.7%	15.1%	17.6%	13.8%
90-95%	19.4%	17.5%	19.0%	18.5%	16.0%	23.2%	20.1%	21.2%	20.0%	17.5%	26.6%	24.6%	26.1%	20.8%	18.8%
95% and Over	7.2%	12.6%	12.3%	4.7%	3.8%	6.2%	10.1%	8.6%	4.1%	3.5%	5.6%	9.4%	8.1%	3.6%	3.2%
Missing	0.5%	5.2%	3.2%	5.4%	13.3%	0.1%	3.4%	2.1%	4.7%	10.7%	0.1%	2.9%	2.1%	4.8%	10.5%
Total Loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Exhibit: Over 90%	26.6%	30.1%	31.2%	23.2%	19.8%	29.3%	30.1%	29.9%	24.2%	20.9%	32.2%	34.0%	34.2%	24.3%	22.1%

Note: Includes home purchase mortgages financing owner-occupied one-unit properties.

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First, the GSEs (and particularly Fannie Mae) have recently increased their purchases of home loans with low downpayments. After remaining about 4 percent of Fannie Mae's purchases between 1997 and 2000, over-95-percent-LTV loans (or less-than-five-percent downpayment loans) jumped to 7.1 percent during 2001, 7.7 percent in 2002 and 11.5 percent in 2003. It is interesting that this jump in less-than-five-percent downpayment loans occurred in the same years that Fannie Mae improved its purchases of loans for low-income homebuyers, as discussed in earlier sections. As a share of Freddie Mac's purchases, over-95-percent-LTV loans increased from 1.1 percent in 1997 to 5.9 percent in 2000, before falling to 4.3 percent in 2001, 4.8 percent in 2002 and 4.7 percent in 2003. If the low-downpayment definition is expanded to ten percent (*i.e.*, over-90-percent-LTV loans), Freddie Mac had about the same percentage (25 percent) of low-downpayment loans during 2001 as Fannie Mae. In fact, under the more expansive definition, Freddie Mac had the same share of over-90-percent-LTV loans in 2001 as it did in 1997 (about 25 percent), while Fannie Mae exhibited only a modest increase in the share of its purchases with low downpayments (from 23.2 percent in 1997 to 25.4 percent in 2001). The share of over-90-percent-LTV loans in Freddie Mac's purchases fell sharply from 25.0 percent in 2001 to 21.9 percent in 2002 and 19.9 percent in 2003, while the share in Fannie Mae's purchases fell more modestly from 25.4 percent in 2001 to 24.2 percent in 2002 before rebounding to 25.3 percent in 2003.

Second, loans that qualify for the housing goals have lower downpayments than non-qualifying loans. In 2001 and 2002, over-95-percent-LTV loans accounted for about 15 percent of Fannie Mae's purchases of special affordable loans, 13 percent of low-mod loans, and 12 percent of underserved area loans, compared with about 7.5 percent of Fannie Mae's purchases of all home loans. (See Table A.29.) In 2003 these percentages increased to 23, 19 and 19 percent for special affordable, low-mod and underserved areas respectively. These low-downpayment shares for 2001, 2002 and 2003 were double those for 2000 when over-95-percent-LTV loans accounted for 8.4 percent of Fannie Mae's purchases of special affordable loans and about 7 percent of its purchases of low-mod and underserved area loans. Fannie Mae's low-downpayment shares during 2001 were higher than Freddie Mac's shares of 12.3 percent for special affordable loans and about 9 percent for low-mod and underserved area loans. Between 2001 and 2003, Freddie Mac's over-95-percent-LTV shares fell sharply to 3–4 percent for the three housing goal categories, while Fannie Mae's shares increased to the 13–23 percent range. Under the more expansive, over-90-percent-LTV definition, almost one-third of Fannie Mae's goals-qualifying purchases during 2001 would be considered low downpayment, as would a slightly smaller percentage of Freddie Mac's purchases. However, during 2003, Freddie Mac's over-90-percent-LTV shares for the goals-qualifying loans fell to 20–22 percent.

Third, a noticeable pattern among goals-qualifying loans purchased by the GSEs is the predominance of loans with high downpayments. For example, 54.3 percent of special affordable home loans purchased by Freddie Mac during 2003 had a downpayment of at least 20 percent, a percentage not much lower than the high-downpayment share (59.5 percent) of all Freddie Mac's home loan purchases. Similarly, 49.8 percent of the home loans purchased by Fannie Mae in underserved areas during 2003 had a twenty percent or higher downpayment, compared with 54.6 percent of all home loans purchased by Fannie Mae.

Thus, the data in Tables A.28 and A.29 show a preponderance of high downpayment loans, even among lower-income borrowers who qualify for the housing goals. The past focus of the GSEs on high-downpayment loans provides some insight into a study by staff at the Federal Reserve Board who found that the GSEs have offered little credit support to the lower end of the mortgage market.[310] The fact that approximately half of the goals-qualifying loans purchased by the GSEs have a downpayment of over twenty percent is also consistent with findings reported earlier concerning the GSEs' minimal service to first-time homebuyers, who experience the most problems raising cash for a downpayment. On the other hand, the recent experience of Fannie Mae suggests that purchasing low-downpayment loans may be one technique for reaching out and funding low-income and minority families who are seeking to buy their first home.

13. Other Studies of the GSEs' Performance Relative to the Market

This section summarizes briefly the main findings from other studies of the GSEs' affordable housing performance. These include studies by the HUD and the GSEs as well as studies by academics and research organizations.

Freeman and Galster Study.[311] A recent study by Lance Freeman and George Galster uses econometric analysis to test whether the Government-Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac purchases of home mortgages in neighborhoods traditionally underserved by financial institutions stimulate housing market activity in those neighborhoods. Specifically, this study analyzes data of single-family home sales volumes and prices of mortgages originated from 1993–1999 in Cleveland, OH.

The study concludes that aggressive secondary market purchasing behavior by non-GSE entities stimulated sales volumes and prices of homes in low-income and predominantly minority-occupied neighborhoods of Cleveland. The study results also showed a positive relationship between home transaction activity and the actions of the secondary mortgage market, and concludes that the secondary mortgage market (and the non-GSE sector in particular) purchases of mortgages had a positive effect on the number of sales transactions one year later. However, the study also concludes that although non-GSE purchases of non-home purchase mortgages appeared to boost prices one and two years later, no consistent impacts of purchasing rates on sales prices could be observed. In addition, there was no robust evidence that GSE purchasing rates were positively associated with single-family home transactions volumes or sales prices during any periods.

Urban Institute Rural Markets Study.[312] A study by Jeanette Bradley, Noah Sawyer, and Kenneth Temkin uses both quantitative and qualitative data to explore the issue of GSE service to rural areas. The study first summarizes the existing research on rural lending and GSE service to rural areas. It then reviews the current underwriting guidelines of Fannie Mae, Freddie Mac, the USDA Rural Housing Service, and Farmer Mac, focusing on issues relevant to rural underwriting. The GSE public-use database is used to analyze GSE non-metro loan purchasing patterns from 1993–2000. Finally, the study presents the results of a series of discussions conducted with key national industry and lender experts and local experts in three rural sites in south-central Indiana, southwestern New Mexico and southern New Hampshire chosen for the diversity of their region, population, economic structures, and housing markets.

The authors of the study conclude that while Fannie Mae and Freddie Mac have increased their lending to rural areas since 1993, their non-metro loan purchases still lag behind their role in metro loan purchases, particularly in regard to the percentage of affordable loans. From the discussions with experts, the authors of the study make the following policy recommendations: Underserved populations and rural areas should be specifically targeted at the census-tract level; HUD should set manufactured housing goals; HUD should consider implementing a survey of small rural lenders or setting up an advisory group of small rural lenders in order to determine their suggestions for creating stronger relationships between the GSEs and rural lenders with the goal of increasing GSE non-metro purchase rates.

Urban Institute GSE Impacts Study.[313] A report by Thomas Thibodeau, Brent Ambrose, and Kenneth Temkin analyzes the extent to which the GSEs' responses to the Federal Housing Enterprises Financial Safety and Soundness Act's (FHEFSSA) affordable housing goals have had their intended effect of making low- and moderate-income families better off. Specifically the report examines several methodologies determining that the conceptual model created by Van Order in 1996[314] provided the most complete description of how the primary and secondary markets interact. This model was then applied in a narrow scope to capital market outcomes which included GSE market shares and effective borrowing costs,

[310] Canner, *et al., op. cit.*

[311] The Impact of Secondary Mortgage Market and GSE Purchases on Underserved Neighborhood Housing Markets: Final Report to HUD. July 2002.

[312] *GSE Service to Rural Areas,* 2002.

[313] *An Analysis of the Effects of the GSE Affordable Goals on Low- and Moderate-Income Families,* 2001.

[314] Van Order, Robert. 1996. ''Discrimination and the Secondary Mortgage Market.'' In John Goering and Ronald Wienk, eds. Mortgage Discrimination, Race, and Federal Policy. The Urban Institute Press, Washington, DC: 335–363.

and housing market outcomes that include low- and moderate-income homeownership rates. Finally, metropolitan American Housing Survey (AHS) data for eight cities were used to conduct empirical analyses of the two categories of outcomes. These cities included areas surveyed in 1992, the year before HUD adopted the affordable housing goals, to provide the baseline for the analysis. Four metropolitan areas were surveyed in 1992 and again in 1996: Cleveland, Indianapolis, Memphis and Oklahoma City. Four cities were surveyed in 1992 and again in 1998: Birmingham, Norfolk, Providence and Salt Lake City.

The study's empirical analysis suggests that the GSE affordable goals have helped to make homeownership more attainable for target families. The assessment of the effects of the affordable goals on capital markets showed that the GSE share of the conventional conforming market has increased, especially for lower income borrowers and neighborhoods. The study also concludes that the affordable housing goals have an impact on the purchase decisions of Fannie Mae and Freddie Mac. The study also finds that interest rates are lower in markets in which Fannie Mae and Freddie Mac purchase a higher proportion of conventional loans. Finally, the study's analysis shows that overall lending volume in a metropolitan area increases when the GSEs purchase seasoned loans.

Specifically, that homeownership rates increased at a faster rate for low-income families when compared to all families, and that in a subset of MSAs, minority homeownership rates also grew faster when compared to overall homeownership changes in those MSAs.

Finally, the affordable housing goal effects were examined for 80 MSAs in relation to the homeownership rate changes between 1991 and 1997. The study found that the GSEs, by purchasing loans originated to low-income families, helped to reduce the disparity between homeownership rates for lower and higher income families, suggesting that the liquidity created when the GSEs purchase loans originated to low-income families is recycled into more lending targeted to lower income homebuyers.

The authors of the study qualify their results by stating that they are based on available data that does not provide the level of detail necessary to conduct a fully controlled national assessment.

Williams and Bond Study.[315] Richard Williams and Carolyn Bond examine GSE leadership of the mortgage finance industry in making credit available for low- and moderate-income families. Specifically, it asks if the GSEs are doing relatively more of their business with underserved markets than other financial institutions, and whether the GSEs' leadership helps to narrow the gap in home mortgage lending that exists between served and underserved markets. The study uses HMDA data for metropolitan areas and the Public Use Data Base at HUD for compilations of GSE data sets for the entire nation (GSE PUDB File B) to conduct descriptive and multivariate analyses of nationwide lending between 1993 and 2000. Additionally, separate analyses are conducted that include and exclude loans from subprime and manufactured housing lenders.

The study concludes that the GSEs are not leading: They do not purchase relatively more underserved market loans than the primary market makes nor do they purchase as many of these loans as their secondary market competitors. Additionally, the study concludes that the disparities between the GSEs and the primary market are even greater once the growing role of subprime and manufactured housing is considered. The authors admit that there have been signs of progress, particularly in 1999 and 2000 when primary market lending to underserved markets increased and GSE purchases of underserved market loans increased even faster. Regardless, the study concludes that there continues to be significant racial, economic, and geographic disparities in the way that the benefits of GSE activities are distributed and that the benefits of GSE activities still go disproportionately to members of served rather than underserved markets.

14. The GSEs' Support of the Mortgage Market for Single-Family Rental Properties

The 1996 Property Owners and Managers Survey reported that 49 percent of rental units are found in the ''mom and pop shops'' of the rental market—''single-family'' rental properties, containing 1–4 units. These small properties are largely individually-owned and managed, and in many cases the owner-managers live in one of the units in the property. They include many properties in older cities, in need of financing for rehabilitation. Single-family rental units play an especially important role in lower-income housing, over half of such units are affordable to very low-income families.

There is not, however, a strong secondary market for single-family rental mortgages. While single-family rental properties comprise a large segment of the rental stock for lower-income families, they make up a small portion of the GSEs' business. Between 1999 and 2002, single-family rental properties accounted for only 7.6 percent of total (both single-family and multifamily) units financed by the GSEs during this period. It follows that since single-family rentals make up such a small part of the GSEs business, they have not penetrated the single-family rental market to the same degree that they have penetrated the owner-occupant market. Table A.30 below shows that between 1999 and 2002, the GSEs financed 61 percent of owner-occupied dwelling units in the conventional conforming market, but only 40 percent of single-family rental units.

There are a number of factors that have limited the development of the secondary market for single-family rental property mortgages thus explaining the lack of penetration by the GSEs. Little is collectively known about these properties as a result of the wide spatial dispersion of properties and owners, as well as a wide diversity of characteristics across properties and individuality of owners. This makes it difficult for lenders to properly evaluate the probability of default and severity of loss for these properties.

Single-family rental properties could be important for the GSEs housing goals, especially for meeting the needs of lower-income families. Between 1999 and 2002, 87 percent of the GSEs' single-family rental units qualified for the Low- and Moderate-Income Goal, compared with 40 percent of one-family owner-occupied properties. (See Table A.30.) This heavy focus on lower-income families meant that single-family rental properties accounted for 14 percent of the units qualifying for the Low- and Moderate-Income Goal, even though they accounted for 7.6 percent of the total units (single-family and multifamily) financed by the GSEs.

Given the large size of this market, the high percentage of these units which qualify for the GSEs' housing goals, and the weakness of the secondary market for mortgages on these properties, an enhanced presence by Fannie Mae and Freddie Mac in the single-family rental mortgage market would seem warranted.[316] Single-family rental housing is an important part of the housing stock because it is an important source of housing for lower-income households.

Despite the size and importance of single-family rental properties for low-income people, HUD received several comments advocating exclusion of single-family rentals from goals consideration. These commenters pointed out that single-family owner-occupiers often maintain their properties more effectively than single-family absentee landlords or their tenants. HUD was asked to exclude single-family investor owned properties to reduce these neighborhood effects.

Community associations raise an important issue for neighborhood development. However, they do not address the question of effective goals promotion for all segments of the housing market. They compare maintenance by owner-occupiers to maintenance by investors in the single-family market. This does not address the housing outcomes for tenants with access to single-family rental compared to tenants in multifamily rental. With nearly half of rental units in older cities composed of smaller single-family units, denial of goals eligibility for single-family investors would exclude a substantial proportion of housing units available to low income people.

Furthermore, single-family investors provide additional market benefits to the housing system. The whole structure of the GSEs provides liquidity to the housing market by allowing investors additional channels to fund mortgages. The question is not always between single-family investors and single-family owner-occupiers. Sometimes, the question is between a single-

[315] *Are the GSEs Leading, and if So Do They Have Any Followers? An Analysis of the GSEs' Impact on Home Purchase Lending to Underserved Markets During the 1990s.* University of Notre Dame Working Paper and Technical Series Number 2003–2. 2002.

[316] A detailed discussion of the GSEs' activities in this area is contained in Theresa R. Diventi, *The GSEs' Purchases of Single-Family Rental Property Mortgages,* Housing Finance Working Paper No. HF–004, Office of Policy Development and Research, Department of Housing and Urban Development, (March 1998).

family investor and a property unable to be sold or even abandoned. Although the goals strongly support home ownership for low-income neighborhoods, investors in single-family properties also play an important role.

F. Factor 4: Size of the Conventional Conforming Mortgage Market Serving Low- and Moderate-Income Families Relative to the Overall Conventional Conforming Market

The Department estimates that dwelling units serving low- and moderate-income families will account for 51–56 percent of total units financed in the overall conventional conforming mortgage market during 2005–2008, the period for which the Low- and Moderate-Income Housing Goal will be effective. The market estimates exclude B&C loans and allow for much more adverse economic and market affordability conditions than have existed recently. The detailed analyses underlying these estimates are presented in Appendix D.

G. Factor 5: GSEs' Ability to Lead the Industry

FHEFSSA requires the Secretary, in determining the Low- and Moderate-Income Housing Goal, to consider the GSEs' ability to ''lead the industry in making mortgage credit available for low- and moderate-income families.'' Congress indicated that this goal should ''steer the enterprises toward the development of an increased capacity and commitment to serve this segment of the housing market'' and that it ''fully expect[ed] [that] the enterprises will need to stretch their efforts to achieve [these goals].''[317]

The Department and independent researchers have published numerous studies examining whether or not the GSEs have been leading the single-family market in terms of their affordable lending performance. This research, which is summarized in Section E, concludes that the GSEs have generally lagged behind primary lenders in funding first-time homebuyers, lower-income borrowers and underserved communities, although Fannie Mae's recent performance has placed it ahead of the special affordable and low-mod markets for single-family-owner loans. As required by FHEFSSA, the Department has produced estimates of the portion of the total (single-family and multifamily) mortgage market that qualifies for each of the three housing goals (see Appendix D). Congress intended that the Department use these market estimates as one factor in setting the percentage target for each of the housing goals. The Department's estimate for the size of the Low- and Moderate-Income market is 51–56 percent, which is higher than the GSEs' performance on that goal.

This section provides another perspective on the GSEs' performance by examining the share of the total conventional conforming mortgage market and the share of the goal-qualifying markets (low-mod, special affordable, and underserved areas) accounted for by the GSEs' purchases. This analysis, which is conducted by product type (single-family owner, single-family rental, and multifamily), shows the relative importance of the GSEs in each of the goal-qualifying markets.

1. GSEs' Role in Major Sectors of the Mortgage Market

Tables A.30 and A.31a compare GSE mortgage purchases with HUD's estimates of the numbers of units financed in the conventional conforming market. Table A.30 presents aggregate data for 1999–2002 while Table A.31a presents more summary market share data for individual years 2000, 2001 and 2002.[318] (As explained below, Tables A.31b and A.31c repeat this information but for lower multifamily shares of the mortgage market.) HUD estimates that there were 47,551,039 owner and rental units financed by new conventional conforming mortgages between 1999 and 2002. Fannie Mae's and Freddie Mac's mortgage purchases financed 26,118,927 of these dwelling units, or 55 percent of all dwelling units financed. As shown in Table A.30, the GSEs have played a smaller role in the goals-qualifying markets than they have played in the overall market. Between 1999 and 2002, new mortgages were originated for 26,051,771 dwelling units that qualified for the Low- and Moderate-Income Goal; the GSEs low-mod purchases financed 12,608,215 dwelling units, or 48 percent of the low-mod market. Similarly, the GSEs' purchases accounted for 48 percent of the underserved areas market, but only 41 percent of the special affordable market. Obviously, the GSEs did not lead the industry during this period in financing units that qualify for the three housing goals. They need to improve their performance and it appears that there is ample room in the non-GSE portions of the goals-qualifying markets for them to do so. For instance, the GSEs were not involved in three-fifths of the special affordable market during the 1999-to-2002 period.

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[317] Senate Report 102–282, May 15, 1992, p. 35.

[318] Tables A.30 and A.31 examine GSE purchases on a ''going forward basis by origination year''. Specifically, it considers GSE purchases of: (a) 2000 mortgage originations during 2000, 2001, 2002 and 2003; (b) 2001 originations during 2001, 2002 and 2003; and (c) 2002 originations during 2002 and 2003. In other words, this analysis looks at the GSEs' purchases of a particular origination year cohort through 2003. This approach contrasts with the approach that examines GSE purchases on a ''backward looking basis by purchase year'', for example, GSE purchases during 2000 of both new 2000 originations and originations during previous years (the latter called ''prior-year'' or seasoned loans). Either approach is a valid method for examining GSE purchases; in fact, when analyzing aggregated data such as the combined 1999–2002 data in Table A.30, the two approaches yield somewhat similar results. HUD's methodology for deriving the market estimates is explained in Appendix D. B&C loans have been excluded from the market estimates in Tables A.30 and A.31.

Table A.30

Number of Newly-Mortgaged Units by Type in the 1999-2002 Conventional Conforming Market Compared To Fannie Mae and Freddie Mac Purchases

	Single-Family Owner		Single-Family Rental		Multifamily		Total Rental		Total Market	
Total Units										
Market	35,501,562	74.7%	5,031,433	10.6%	7,018,044	14.8%	12,049,477	25.3%	47,551,039	100.0%
Fannie Mae	12,529,937	81.8%	1,301,070	8.5%	1,482,109	9.7%	2,783,179	18.2%	15,313,116	100.0%
Freddie Mac	9,122,244	84.4%	686,131	6.3%	997,436	9.2%	1,683,567	15.6%	10,805,811	100.0%
GSE Total	21,652,181	82.9%	1,987,201	7.6%	2,479,545	9.5%	4,466,746	17.1%	26,118,927	100.0%
GSE % of Market	61.0%		39.5%		35.3%		37.1%		54.9%	
Low-Mod Units										
Market	15,207,242	58.4%	4,528,290	17.4%	6,316,239	24.2%	10,844,529	41.6%	26,051,771	100.0%
Fannie Mae	5,030,333	66.9%	1,129,485	15.0%	1,361,022	18.1%	2,490,507	33.1%	7,520,841	100.0%
Freddie Mac	3,561,496	70.0%	600,065	11.8%	925,814	18.2%	1,525,878	30.0%	5,087,375	100.0%
GSE Total	8,591,830	68.1%	1,729,550	13.7%	2,286,836	18.1%	4,016,385	31.9%	12,608,215	100.0%
GSE % of Market	56.5%		38.2%		36.2%		37.0%		48.4%	
Underserved Area Units										
Market	9,627,980	62.1%	2,212,607	14.3%	3,672,576	23.7%	5,885,183	37.9%	15,513,163	100.0%
Fannie Mae	3,102,848	70.6%	678,042	15.4%	616,263	14.0%	1,294,305	29.4%	4,397,153	100.0%
Freddie Mac	2,202,637	73.7%	334,675	11.2%	451,077	15.1%	785,752	26.3%	2,988,389	100.0%
GSE Total	5,305,485	71.8%	1,012,717	13.7%	1,067,340	14.5%	2,080,057	28.2%	7,385,542	100.0%
GSE % of Market	55.1%		45.8%		29.1%		35.3%		47.6%	
Special Affordable Units										
Market	5,425,061	43.7%	2,918,232	23.5%	4,070,466	32.8%	6,988,698	56.3%	12,413,759	100.0%
Fannie Mae	1,653,476	53.8%	633,572	20.6%	786,892	25.6%	1,420,464	46.2%	3,073,940	100.0%
Freddie Mac	1,188,829	58.6%	339,990	16.8%	500,427	24.7%	840,417	41.4%	2,029,246	100.0%
GSE Total	2,842,304	55.7%	973,562	19.1%	1,287,319	25.2%	2,260,882	44.3%	5,103,186	100.0%
GSE % of Market	52.4%		33.4%		31.6%		32.4%		41.1%	

Source: The market data are the estimated number of newly mortgaged units between 1999 and 2002. The single-family owner market data exclude B&C loans. See Appendix D for an explanation of the market methodology. The GSE data include units from mortgages originated between 1999 and 2002 and purchased by one of the GSEs during 1999 and 2003. GSE data with missing affordability or geocode are reallocated based the distribution of existing data.

Table A.31a

GSE Share of Newly-Mortgaged Units Conventional Conforming Market 2000, 2001, and 2002

	Single-Family Owner	Single-Family Rental	Multifamily	Total Rental	Total Market
2000 Financed Units					
Total	48%	30%	35%	33%	44%
Low-Mod	45%	29%	37%	34%	40%
Underserved Area	44%	36%	28%	31%	38%
Special Affordable	41%	26%	32%	30%	34%
2001 Financed Units					
Total	55%	38%	34%	36%	51%
Low-Mod	53%	38%	35%	37%	46%
Underserved Area	50%	43%	29%	34%	44%
Special Affordable	49%	34%	30%	32%	39%
2002 Financed Units					
Total	74%	51%	41%	46%	68%
Low-Mod	69%	49%	42%	45%	60%
Underserved Area	68%	59%	33%	44%	59%
Special Affordable	67%	43%	37%	40%	53%

Source: See notes to Table A.30. The first figure ("48") is interpreted as follows: Fannie Mae's and Freddie Mac's acquisitions (during 2000, 2001, 2002, and 2003) of single-family-owner home purchase mortgages originated in 2000 accounted for 48 percent of all such mortgages originated that year in the conventional conforming market.

Table A.31b

Number of Newly-Mortgaged Units by Type in the 1999-2002 Conventional Conforming Market Compared To Fannie Mae and Freddie Mac Purchases: Lower Multifamily Market Shares

	Single-Family Owner		Single-Family Rental		Multifamily		Total Rental		Total Market	
Total Units										
Market	35,501,562	76.3%	5,031,433	10.8%	5,991,036	12.9%	11,022,469	23.7%	46,524,031	100.0%
Fannie Mae	12,529,937	81.8%	1,301,070	8.5%	1,482,109	9.7%	2,783,179	18.2%	15,313,116	100.0%
Freddie Mac	9,122,244	84.4%	686,131	6.3%	997,436	9.2%	1,683,567	15.6%	10,805,811	100.0%
GSE Total	21,652,181	82.9%	1,987,201	7.6%	2,479,545	9.5%	4,466,746	17.1%	26,118,927	100.0%
GSE % of Market	61.0%		39.5%		41.4%		40.5%		56.1%	
Low-Mod Units										
Market	15,207,242	60.5%	4,528,290	18.0%	5,391,932	21.5%	9,920,222	39.5%	25,127,464	100.0%
Fannie Mae	5,030,333	66.9%	1,129,485	15.0%	1,361,022	18.1%	2,490,507	33.1%	7,520,841	100.0%
Freddie Mac	3,561,496	70.0%	600,065	11.8%	925,814	18.2%	1,525,878	30.0%	5,087,375	100.0%
GSE Total	8,591,830	68.1%	1,729,550	13.7%	2,286,836	18.1%	4,016,385	31.9%	12,608,215	100.0%
GSE % of Market	56.5%		38.2%		42.4%		40.5%		50.2%	
Underserved Area Units										
Market	9,627,980	64.3%	2,212,607	14.8%	3,135,059	20.9%	5,347,666	35.7%	14,975,646	100.0%
Fannie Mae	3,102,848	70.6%	678,042	15.4%	616,263	14.0%	1,294,305	29.4%	4,397,153	100.0%
Freddie Mac	2,202,637	73.7%	334,675	11.2%	451,077	15.1%	785,752	26.3%	2,988,389	100.0%
GSE Total	5,305,485	71.8%	1,012,717	13.7%	1,067,340	14.5%	2,080,057	28.2%	7,385,542	100.0%
GSE % of Market	55.1%		45.8%		34.0%		38.9%		49.3%	
Special Affordable Units										
Market	5,425,061	45.9%	2,918,232	24.7%	3,474,800	29.4%	6,393,032	54.1%	11,818,093	100.0%
Fannie Mae	1,653,476	53.8%	633,572	20.6%	786,892	25.6%	1,420,464	46.2%	3,073,940	100.0%
Freddie Mac	1,188,829	58.6%	339,990	16.8%	500,427	24.7%	840,417	41.4%	2,029,246	100.0%
GSE Total	2,842,304	55.7%	973,562	19.1%	1,287,319	25.2%	2,260,882	44.3%	5,103,186	100.0%
GSE % of Market	52.4%		33.4%		37.0%		35.4%		43.2%	

Source: Compared with Table A.30, this table assumes lower multifamily shares in the mortgage market, as explanined in Sections F-H of Appendix D. The market data are the estimated number of newly mortgaged units between 1999-2002. The single-family owner market data exclude B&C loans. See Appendix D for an explanation of the market methodology. The GSE data include units from mortgages originated between 1999 and 2002 and purchased by one of the GSEs during 1999 and 2003. GSE data with missing affordability or geocode are reallocated based the distribution of existing data.

Table A.31c

GSE Share of Newly-Mortgaged Units Conventional Conforming Market 2000, 2001, and 2002 Lower Multifamily Market Share

	Single-Family Owner	Single-Family Rental	Multifamily	Total Rental	Total Market
2000 Financed Units					
Total	48%	30%	41%	37%	45%
Low-Mod	45%	29%	43%	37%	42%
Underserved Area	44%	36%	33%	34%	40%
Special Affordable	41%	26%	38%	33%	36%
2001 Financed Units					
Total	55%	38%	39%	39%	52%
Low-Mod	53%	38%	41%	39%	48%
Underserved Area	50%	43%	33%	37%	46%
Special Affordable	49%	34%	35%	34%	41%
2002 Financed Units					
Total	74%	51%	49%	50%	69%
Low-Mod	69%	49%	49%	49%	62%
Underserved Area	68%	59%	39%	48%	61%
Special Affordable	67%	43%	44%	43%	55%

Source: See notes to Table A.31b. The first figure ("48") is interpreted as follows: Fannie Mae's and Freddie Mac's acquisitions (during 2000, 2001, 2002, and 2003) of single-family-owner home purchase mortgages originated in 2000 accounted for 48 percent of all such mortgages originated that year in the conventional conforming market.

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While the GSEs are free to meet the Department's goals in any manner that they deem appropriate, it is useful to consider their performance relative to the industry by property type. The GSEs accounted for 61 percent of the single-family owner market but only 35 percent of the multifamily market and 40 percent of the single-family rental market (or a combined 37 percent share of the rental market).

Single-Family Owner Market. As stated in the 2000 Rule, the single-family-owner market is the bread-and-butter of the GSEs' business, and based on the financial and other factors discussed below, the GSEs clearly have the ability to lead the primary market in providing credit for low- and moderate-income owners of single-family properties. However, the GSEs have historically lagged behind the market in funding single-family-owner loans that qualify for the housing goals and, as discussed in Section E, they have played a rather small role in funding minority first-time homebuyers. The market share data reported in Table A.30 for the single-family-owner market tell the same story. The GSEs' purchases of single-family-owner loans represented 61 percent of all single-family-owner loans originated between 1999 and 2002, compared with 57 percent of the low-mod loans that were originated, 55 percent of underserved area loans, and 52 percent of the special affordable loans.

The data in Table A.31a indicate the GSEs' growing market share during the heavy refinance years of 2001 and 2002. For example, the GSEs accounted for 74 percent of the overall single-family-owner market in 2002, and 67–69 percent of the markets covered by the three housing goal categories. While this improvement is an encouraging trend, there are ample opportunities for the GSEs to continue their improvement. Almost one-third of the goals-qualifying loans originated during 2002 remained available to the GSEs to purchase; there are clearly affordable loans being originated that the GSEs can purchase. Furthermore, the GSEs' purchases under the housing goals are not limited to new mortgages that are originated in the current calendar year. The GSEs can purchase loans from the substantial, existing stock of affordable loans held in lenders' portfolios, after these loans have seasoned and the GSEs have had the opportunity to observe their payment performance. In fact, based on Fannie Mae's recent experience, the purchase of seasoned loans appears to be one effective strategy for purchasing goals-qualifying loans.

The data in Table A.31a show a strong upward trend from 2000 and 2001 to 2002 in the GSE share of the single-family-owner market. Their share of 2000 financed units in the conventional conforming market totaled 48 percent. This increased to 55 percent in 2001 then to 74 percent in 2002. The large increase in 2002 can be attributed to the relatively low interest rates and heavy refinancing activity in 2003. During such a period, the share of fixed rate mortgage originations increases relative to adjustable rate mortgages. Due to the higher risk associated with fixed rate mortgages, less thrift institutions are willing to hold them, and, thus, more are sold to the GSEs. As a result, during low interest rate periods, the GSE share of mortgages increases.

Single-Family Rental Market. Single-family rental housing is a major source of low-income housing. As discussed in Appendix D, data on the size of the primary market for mortgages on these properties is limited, but available information indicate that the GSEs are much less active in this market than in the single-family owner market. HUD estimates that GSE purchases between 1999 and 2002 totaled only 40 percent of all newly-mortgaged single-family rental units that were affordable to low- and moderate-income families.

As explained in the 2000 Rule, many of these properties are ''mom-and-pop'' operations, which may not follow financing procedures consistent with the GSEs' guidelines. Much of the financing needed in this area is for rehabilitation loans on 2–4 unit properties in older areas, a market in which the GSEs' have not played a major role. However, this sector could certainly benefit from an enhanced role by the GSEs, and the data in Table A.30 indicate that there is room for such an enhanced role, as approximately two-thirds of this market remains for the GSEs to enter.

Once again, Table A.31a shows a large increase in the GSE share of newly-mortgaged units financed in 2002 compared to those financed in 2000 and 2001. As described above for the single-family owner market, this large increase is due to the large share of fixed-rate mortgages, compared to adjustable rate mortgages, originated during 2002.

Multifamily Market. Fannie Mae is the largest single source of multifamily finance in the United States, and Freddie Mac has made a solid reentry into this market over the last nine years. However, there are a number of measures by which the GSEs lag the multifamily market. For example, the share of GSE resources committed to the multifamily purchases falls short of the multifamily proportion prevailing in the overall mortgage market. HUD estimates that newly-mortgaged units in multifamily properties represented almost 15 percent of all (single-family and multifamily) dwelling units financed between 1999 and 2002.[319] As shown in Table A.30, multifamily acquisitions represented 9.5 percent of dwelling units financed by the GSEs between 1999 and 2002.

The GSEs' role in the multifamily market is significantly smaller than in single-family. As shown in Table A.30, GSE purchases have accounted for 35 percent of newly financed multifamily units between 1999 and 2002—a market share much lower than their 61 percent share of the single-family-owner market. Stated in terms of portfolio shares, single-family-owner loans accounted for 83 percent of all dwelling units financed by the GSEs during this period, versus 75 percent of all units financed in the conventional conforming market.

While it is recognized that the GSEs have been increasing their multifamily purchases, a further enlargement of their role in the multifamily market seems feasible and appropriate, particularly in the affordable (lower rent) end of the market. As noted in Section D.3, market participants believe that the GSEs have been conservative in their approaches to affordable multifamily lending and underwriting.[320] Certainly the GSEs face a number of challenges in better meeting the needs of the affordable multifamily market. For example, thrifts and other depository institutions may sometimes retain their best loans in portfolio, and the resulting information asymmetries may act as an impediment to expanded secondary market transaction volume.[321] However, the GSEs have demonstrated that they have the depth of expertise and the financial resources to devise innovative solutions to problems in the multifamily market. The GSEs can build on their recent records of increased multifamily lending and innovative products to make further in-roads into the affordable market. As explained in Section D.3, the GSEs have the expertise and market presence to push simultaneously for market standardization and for programmatic flexibility to meet the special needs and circumstances of the lower-income portion of the multifamily market.

As discussed in Appendix D, the GSEs questioned HUD's historical estimates of the multifamily market as too high. Section C of Appendix D discusses these comments and responds. As indicated in Table A.30, multifamily loans accounted for 14.8 percent of all financed units in the market, excluding B&C loans. As reported in Appendix D, HUD also conducted sensitivity analyses that reduced its 1999–2002 multifamily shares for the market by approximately two percentage points. The results for these lower multifamily market shares are reported in Table A.31b (1999–2002 aggregate results) and Table A.31c (2000–2002 individual year results). In this case, 1999–2002 multifamily units decreased from 7,018,044 units to 5,991,036 units (reducing the multifamily share from 14.8 percent to 12.9 percent). With these reduced multifamily market numbers, the GSEs' share of the multifamily market increased from 35 percent to 41 percent. The GSEs also accounted for higher shares of the goals-qualifying *multifamily* market: 42 percent for low-mod units, 34 percent for underserved area units, and 37 percent for special affordable units. In this case, the GSEs' shares of the *overall* goals-qualifying markets increased as follows: low-mod—from 48 percent (see right column of Table A.30) to 50 percent (see right column

[319] Based on Table A.30, multifamily properties represented 14.8 percent of total units financed between 1999 and 2002 (obtained by dividing 7,018,044 multifamily units by 47,551,039 ''Total Market'' units). Increasing the single-family-owner number in Table A.30 by 2,648,757 to account for excluded B&C mortgages increases the ''Total Market'' number to 50,199,796, which produces a multifamily share of 14.0 percent. See Appendix D for discussion of the B&C market.

[320] Abt Associates, *op. cit.* (August 2002).

[321] The problem of secondary market ''adverse selection'' is described in James R. Follain and Edward J. Szymanoski. ''A Framework for Evaluating Government's Evolving Role in Multifamily Mortgage Markets,'' *Cityscape: A Journal of Policy Development and Research* 1(2), 1995.

of Table A.31b); underserved areas—from 48 percent to 49 percent; and special affordable—from 41 percent to 43 percent.

Conclusions. While HUD recognizes that some segments of the market may be more challenging for the GSEs than others, the data reported in Table A.30 and Tables A.31a–c show that the GSEs have ample opportunities to purchase goals-qualifying mortgages. Furthermore, if a GSE makes a business decision to not pursue certain types of goals-qualifying loans in one segment of the market, they are free to pursue goals-qualifying owner and rental property mortgages in other segments of the market. As market leaders, the GSEs should be looking for innovative ways to pursue this business. Furthermore, there is evidence that the GSEs can earn reasonable returns on their goals business. The Regulatory Analysis that accompanies this final rule provides evidence that the GSEs can earn financial returns on their purchases of goals-qualifying loans that are only slightly below their return on equity from their normal business.

2. Qualitative Dimensions of the GSEs' Ability to Lead the Industry

This section discusses several qualitative factors that are indicators of the GSEs' ability to lead the industry in affordable lending. It discusses the GSEs' role in the mortgage market; their ability, through their underwriting standards, new programs, and innovative products, to influence the types of loans made by private lenders; their development and utilization of state-of-the-art technology; the competence, expertise and training of their staffs; and their financial resources.

a. Role in the Mortgage Market

The GSEs have played a dominant role in the single-family mortgage market. As reported in Section C.3, mortgage purchases by the GSEs reached extraordinary levels in 2001–2003. Purchases by Fannie Mae stood at $568 billion in 2001 and $848 billion in 2002. Freddie Mac's single-family mortgage purchases were $393 billion in 2001 and $475 billion in 2002. The Office of Federal Housing Enterprise Oversight (OFHEO) estimates that the GSEs purchased 40 percent of newly-originated conventional mortgages in 2001. Total GSE purchases, including loans originated in prior years, amounted to 46 percent of conventional originations in 2001.

The dominant position of the GSEs in the mortgage market is reinforced by their relationships with other market institutions. Commercial banks, mutual savings banks, and savings and loans are their competitors as well as their customers—they compete to the extent they hold mortgages in portfolio, but at the same time they sell mortgages to the GSEs. They also buy mortgage-backed securities, as well as the debt securities used to finance the GSEs' portfolios. Mortgage bankers sell virtually all of their prime conventional conforming loans to the GSEs. Private mortgage insurers are closely linked to the GSEs, because mortgages purchased by the enterprises that have loan-to-value ratios in excess of 80 percent are normally required to be covered by private mortgage insurance, in accordance with the GSEs' charter acts.

b. Underwriting Standards for the Primary Mortgage Market

The GSEs' underwriting guidelines are followed by virtually all originators of prime mortgages, including lenders who do not sell many of their mortgages to Fannie Mae or Freddie Mac. The guidelines are also commonly followed in underwriting ''jumbo'' mortgages, which exceed the maximum principal amount which can be purchased by the GSEs (the conforming loan limit)—such mortgages eventually might be sold to the GSEs, as the principal balance is amortized or when the conforming loan limit is otherwise increased. Changes that the GSEs have made to their underwriting standards in order to address the unique needs of low-income families were discussed in Section C.4 of this Appendix. The GSEs' market influence is one reason these new, more flexible underwriting standards have spread throughout the market. Because the GSEs' guidelines set the credit standards against which the mortgage applications of lower-income families are judged, the enterprises have a profound influence on the rate at which mortgage funds flow to low- and moderate-income borrowers and underserved neighborhoods.

As discussed below, the GSEs' new automated underwriting systems are widely used to originate mortgages in today's market. As discussed in Sections C.7 and C.8, the GSEs have started adapting their underwriting systems for subprime loans and other loans that have not met their traditional underwriting standards.

c. State-of-the-Art Technology

Both GSEs are in the forefront of new developments in mortgage industry technology. Automated underwriting and online mortgage processing are a couple of the new technologies that have impacted the mortgage market, expanding homeownership opportunities. This section provides an overview of these new technologies and the extent of their use.

Each enterprise released an automated underwriting system in 1995—Freddie Mac's ''Loan Prospector'' (LP) and Fannie Mae's ''Desktop Underwriter'' (DU). During 2001 and 2002, roughly 60 percent of all newly-originated mortgages the GSEs purchased were processed through these systems. Lenders and brokers used LP to evaluate 7.3 million loan applications in 2001, 8.2 million in 2002,[322] and 9.5 million in 2003. Similarly, DU was used to evaluate 8 million loans in 2001, over 10 million in 2002, and 14.8 million loans in 2003. The GSEs' systems have also been adapted for FHA and jumbo loans. Automated underwriting systems are being further adapted to facilitate risk-based pricing, which enables mortgage lenders to offer each borrower an individual rate based on his or her risk. As discussed earlier, concerns about the use of automated underwriting and risk-based pricing include the disparate impact on minorities and low-income borrowers and the ''black box'' nature of the score algorithm.

The GSEs are using their state-of-the-art technology in certain ways to help expand homeownership opportunities. For example, Fannie Mae has developed Fannie Mae Property GeoCoder a computerized mapping service offered to lenders, nonprofit organizations, and state and local governments to help them determine whether a property is located in an area that qualifies for Fannie Mae's community lending products designed to increase homeownership and revitalization in traditionally underserved areas. In addition, eFannieMae.com is Fannie Mae's business-to-business Web site where lenders can access product information and important technology tools, view upcoming events, and receive news about training opportunities. This site receives on average 80,000 visitors per week.[323] Freddie Mac has introduced in recent years Internet-based debt auctions, debt repurchase operations, and debt exchanges. These mechanisms benefit investors by providing more uniform pricing, greater transparency and faster price discovery—all of which makes Freddie Mac debt more attractive to investors and reduces the cost of funding mortgages.[324] In addition, Freddie Mac has provided automated tools for lenders to identify and work with borrowers most likely to encounter problems making their mortgage payments. EarlyIndicator has become the industry standard for default management technology. It can reduce the consequences of mortgage delinquency for borrowers, servicers and investors.[325]

The GSEs are also expanding homeownership opportunities through the use of the Internet in processing mortgage originations. New online mortgage originations reached $267.6 billion in the first half of 2002, compared with $97 billion for the first six months of 2001. The 2002 six-month volume comprised 26.5 percent of the estimated $1.01 trillion in total mortgage originations for the same time period.[326] Freddie Mac made Loan Prospector on the Internet service available to lenders for their retail operations. Freddie Mac also adopted the mortgage industry's XML (extensible markup language) data standard, which is integral to streamlining and simplifying Internet-based transactions. In addition, Congress enacted legislation that allows the use of electronic signature in contracts in 2001, making a completely electronic mortgage transaction possible. With the use of electronic signatures, electronic mortgages are expected to improve the mortgage process, further reducing origination and servicing costs. In October 2000, Freddie Mac

[322] This section is based heavily on ''DU and LP Usage Continues to Rise,'' in *Inside Mortgage Technology* published by Inside Mortgage Finance, January 27, 2003, page 1–2.

[323] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, pp. 10–11.

[324] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 14.

[325] Freddie Mac, *2002 Annual Housing Activities Report,* 2003, p. 52.

[326] *Inside Mortgage Finance,* ''Online Volume Comprises One-Fourth of Total Originations in First Half '02,'' September 20, 2002, p. 8.

purchased its first electronic mortgage under the new law.

The GSEs also offer a variety of other online tools and applications that have the potential to make the mortgage loan process more cost effective and efficient for lenders. Freddie Mac, for example, has launched dontborrowtrouble.com, which contains information on local anti-predatory lending campaigns, consumer tips on avoiding predatory lending, and information on how to start a local campaign and obtain additional resources.[327] Fannie Mae offers ''HomeBuyer Funds Finder,'' a one-stop online resource designed for lenders and other housing professionals, enables users to access a database of local housing subsidy programs available for low- and moderate-income borrowers. In 2002, the HomeBuyer Funds Finder Web site received over 24,500 hits.[328] ''Home Counselor Online'' provides homeownership counselors with the necessary tools to help consumers financially prepare to purchase a home. In 2003, 641 counselors representing over 2,000 organizations used Home Counselor Online.[329] ''True Cost Calculator 2.0'' is designed to help homebuyers make informed home purchase decisions by helping them compare loan products and prices. Over 60 Fannie Mae partners officer the True Cost Calculator through their Web sites and a Spanish version is also available on Univision.com.[330] A more complete list of Fannie Mae's online tool and applications can be found in its Annual Housing Activities Report. In 2002, Fannie Mae's total eBusiness volume was $1.1 trillion, up from $800 billion in 2000.[331]

d. Staff Resources

Both Fannie Mae and Freddie Mac are well-known throughout the mortgage industry for the expertise of their staffs in carrying out their current programs, conducting basic and applied research regarding mortgage markets, developing innovative new programs, and undertaking sophisticated analyses that may lead to new programs in the future. The leaders of these corporations frequently testify before Congressional committees on a wide range of housing issues, and both GSEs have developed extensive working relationships with a broad spectrum of mortgage market participants, including various nonprofit groups, academics, and government housing authorities. Federal agencies and foreign governments and businesses seek them out for advice and consultation because of their expertise. The role that the GSEs have played in spreading the use of technology throughout the mortgage market reflects the enormous expertise of their staff.

e. Financial Strength

Fannie Mae. The benefits that accrue to the GSEs because of their GSE status, as well as their solid management, have made them two of the nation's most profitable businesses. Fannie Mae's net income was $3.9 billion in 1999, $4.4 billion in 2000, $5.9 billion in 2001, $4.6 billion in 2002,[332] and $7.9 billion in 2003.[333] Fannie Mae's return on equity averaged 24.0 percent over the 1995–99 period—far above the rates achieved by most financial corporations. Fannie Mae's return on equity was 26.0 percent in 2003, while this represented no change from 2002, it was an increase of 3 percent over 2001.[334] In 2003, Fannie Mae's total stockholders' equity increased by 37% to $22.373 million, core business earnings grew by 14 percent ($7.3 billion), credit losses increased by $42 million to $111 million with the resulting credit loss ratio at .006% (represents credit losses divided by average single family mortgage credit book of business) and taxable equivalent revenues grew by 24 percent.[335]

Fannie Mae's basic net earnings per common share increased from $3.75 in 1999 to $7.93 in 2003, dividends per common share have increased from $.96 in 1998 to $1.68 in 2003, a 27% increase over 2002, and operating earnings per diluted common share increased from 2002 to 2003 by 71% to $7.72.[336]

Freddie Mac. Freddie Mac has shown similar trends. Freddie Mac's net income was $3.158 billion in 2001, $10.090 billion in 2002, and $4.891 billion in 2003, and total stockholder's equity increased by 10% over 2002 to $31.562 billion. Freddie Mac's return on equity averaged 23.4 percent over the 1995–1999 period, also well above the rates achieved by most financial corporations. Credit losses increased by $8 million to $82 million with the resulting credit loss ratio at 0.7 (represents annualized credit losses divided by average total mortgage portfolio). Basic earnings per common share (after cumulative effect of change in accounting principles, net of taxes) was $4.25 in 2001, $14.23 in 2002 and $6.80 in 2003. Dividends per common share have increased from 0.80 in 2001 to $1.04 in 2003, an 18% increase over 2002, and operating earnings per diluted common share (after cumulative effect of change in accounting principles, net of taxes) decreased from 2002 to 2003 by $7.39 to $6.79.[337]

Other Indicators. Additional indicators of the strength of the GSEs are provided by various rankings of American corporations. *Business Week* has reported that among Standard & Poor's performance ranking of 500 companies in 2004, Fannie Mae was ranked 117, down from 91 in 2003 and Freddie Mac was listed as ''INC'' for 2004 and 16th for 2003. Additionally, Fannie Mae was ranked as 29th in overall market value, 17th in sales and 9th in profits, and Freddie Mac was ranked 59th in market value and ''NR'' in sales and profits.[338] According to Fortune's annual listing of the 500 largest U.S. Corporations, Fannie Mae was ranked 20th in 2003, down from 16th in 2002, and Freddie Mac was ''displaced'' from the ranking in 2003, but ranked 32nd in 2002. Additionally, Fannie Mae ranked 11th for most profitable companies, 3rd for revenues per employee, and in the ''Diversified Financials'' category, they ranked 2nd out of 12 companies.[339] And, according to Fortune's Global 500 listing of the world's largest corporations, Fannie Mae ranked 56th in 2003, (ranking 17th in highest profits) down from 45th in 2002, and Freddie Mac ranked 104th in 2003, down from 90th in 2002.[340]

f. Conclusion About Leading the Industry

In light of these considerations, the Secretary has determined that the GSEs have the ability to lead the industry in making mortgage credit available for low- and moderate-income families.

H. Factor 6: The Need to Maintain the Sound Financial Condition of the GSEs

HUD has undertaken a separate, detailed economic analysis of this final rule, which includes consideration of (a) the financial returns that the GSEs earn on low- and moderate-income loans and (b) the financial safety and soundness implications of the housing goals. Based on this economic analysis and the Office of Federal Housing Enterprise Oversight review, HUD concludes that the goals raise minimal, if any, safety and soundness concerns.

I. Determination of the Low- and Moderate-Income Housing Goals

The annual goal for each GSE's purchases of mortgages financing housing for low- and moderate-income families is being established at 52 percent of eligible units financed in each of calendar years 2005, 53 percent in 2006, 55 percent in 2007, and 56 percent in 2008. This goal will remain in effect thereafter, unless changed by the Secretary prior to that time. In addition, a low- and moderate-income subgoal of 45 percent in 2005, 46 percent in 2006, and 47 percent in both 2007 and 2008 is being established for the GSEs' acquisitions of single-family-owner home purchase loans in metropolitan areas. This subgoal is designed to encourage the GSEs to lead the primary market in offering homeownership

[327] Freddie Mac, *Opening Doors for America's Families: Freddie Mac's Annual Housing Activities Report for 2003,* March 15, 2004, p. 38.

[328] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 12.

[329] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, p. 13.

[330] Fannie Mae, *2003 Annual Housing Activities Report,* 2004, p. 13.

[331] Fannie Mae, *2002 Annual Housing Activities Report,* 2003, p. 10.

[332] The 22% decrease in Fannie Mae's 2002 net income resulted primarily from a $4.508 billion increase in purchased options expense, which occurred due to an increase in the notional amount of purchased options outstanding and the declining interest rate environment. Recorded purchased options expense for 2001 was only $37 million by comparison. *Fannie Mae 2002 Annual Report,* 2003, p. 23.

[333] Fannie Mae, *2003 Annual Report,* ''Financial Highlights.''

[334] Fannie Mae, *2003 Annual Report,* ''Financial Highlights.''

[335] Fannie Mae, *2003 Annual Report,* ''Financial Highlights'' and United States Securities and Exchange Commission form 10–K, p. 108.

[336] Fannie Mae, *2003 Annual Report to Shareholders,* Financial Highlights and Financial Information.

[337] Freddie Mac, Consolidated Statements of Income 2003 and Freddie Mac Core Tables 2003.

[338] ''The Standard and Poor's Five Hundred: Performance Ranking S&P 500'', *Business Week,* April 5, 2004, p. 127.

[339] ''Fortune 500 Largest U.S. Corporations,'' *Fortune,* April 5, 2004, p. F–1.

[340] ''Fortune 500 Largest U.S. Corporations,'' *Fortune,* July 26, 2004, p. 159.

opportunities to low- and moderate-income families. The Secretary's consideration of the six statutory factors that led to the choice of these goals is summarized in this section.

1. Housing Needs and Demographic Conditions

Affordability Problems. Data from the 2000 Census and the American Housing Surveys demonstrate that there are substantial housing needs among low- and moderate-income families. Many of these households are burdened by high homeownership costs or rent payments and will likely continue to face serious housing problems. There is evidence of persistent housing problems for Americans with the lowest incomes. Since 1977, the percentage of U.S. households with worst case needs has hovered around five percent, with the worst year being 1983 (6.03 percent) and the best year being 1999 (4.72 percent). The proportion in 2001 was 4.77 percent, which is not significantly different from the 1999 figure. HUD's analysis of American Housing Survey data reveals that, in 2001, 5.1 million unassisted very-low income renter households had ''worst-case'' housing needs, defined as housing costs greater than 50 percent of household income or severely inadequate housing. Among these households, 90 percent had a severe rent burden, 6 percent lived in severely inadequate housing, and 4 percent suffered from both problems. Among the 34 million renters in all income categories, 6.3 million (19 percent) had a severe rent burden and over one million renters (3 percent) lived in housing that was severely inadequate.

Demographic Trends. Changing population demographics will result in a need for the primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences and overcome information and other barriers that many immigrants and minorities face. It is projected that there will be 1.2 million new households each year over the next decade. The aging of the baby-boom generation and the entry of the baby-bust generation into prime home buying age will have a dampening effect on housing demand. However, the continued influx of immigrants will increase the demand for rental housing, while those who immigrated during the 1980s and 1990s will be in the market for owner-occupied housing. Immigrants and other minorities—who accounted for nearly 40 percent of the growth in the nation's homeownership rate over the past five years—will be responsible for almost two-thirds of the growth in the number of new households over the next ten years. Non-traditional households have become more important, as overall household formation rates have slowed. With later marriages, divorce, and non-traditional living arrangements, the fastest growing household groups have been single-parent and single-person households. As these demographic factors play out, the overall effect on housing demand will likely be sustained growth and an increasingly diverse household population from which to draw new renters and homeowners. According to the National Association of Homebuilders, annual housing demand will average from 1.84 to 2.19 million units over the next decade.[341]

Growth in Single-Family Affordable Lending. Many younger, minority and lower-income families did not become homeowners during the 1980s due to the slow growth of earnings, high real interest rates, and continued house price increases. Over the past ten years, economic expansion, accompanied by low interest rates and increased outreach on the part of the mortgage industry, has improved affordability conditions for these families. As this appendix has explained, there has been a ''revolution in affordable lending'' that has extended homeownership opportunities to historically underserved households. The mortgage industry has offered more customized mortgage products, more flexible underwriting, and expanded outreach to low-income and minority borrowers. Fannie Mae and Freddie Mac have been a big part of this ''revolution in affordable lending''. HMDA data suggest that the industry and GSE initiatives are increasing the flow of credit to underserved borrowers. Between 1993 and 2003, conventional loans to low-income and minority families increased at much faster rates than loans to upper-income and non-minority families. Thus, the 1990s and the early part of the current decade have seen the development of a strong affordable lending market.

Disparities in Housing and Mortgage Markets. Despite this strong growth in affordable lending, serious disparities in the nation's housing and mortgage markets remain. The homeownership rate for African-American and Hispanic households is about 25 percentage points below that of white households. In addition to low income, barriers to homeownership that disproportionately affect minorities and immigrants include: lack of capital for down payment and closing costs; poor credit history; lack of access to mainstream lenders; little understanding of the homebuying process; and continued discrimination in housing markets and mortgage lending. With respect to the latter, a recent HUD-sponsored study of discrimination in the rental and owner markets found that while differential treatment between minority and white home seekers had declined over the past ten years, it continued at an unacceptable level in the year 2000. In addition, disparities in mortgage lending continued across the nation in 2003, when the loan denial rate for African-American applicants was almost three times that for white applicants, even after controlling for income of the applicant. HUD studies also show that African-Americans and Hispanics are subject to discriminatory treatment during the pre-qualification process of applying for a mortgage.

Single-Family Mortgage Market. Heavy refinancing due to low interest rates increased single-family mortgage originations to record levels during 2001–2003. Demographic forces, industry outreach, and low interest rates also kept lending for home purchase at record levels as well. As noted above, the potential homeowner population over the next decade will be highly diverse, as growing demand from immigrants and minorities are expected to sustain the home purchase market, as our population ages. Single-family housing starts are expected to continue in the 1.65–1.70 million range over the next few years. Refinancing of existing mortgages, which accounted for about 60 percent of originations during 2001–2003 is expected to return to more normal levels. As this Appendix has explained, the GSEs will continue to play a dominant role in the single-family market and will both impact and be affected by major market developments such as the growth in subprime lending and the increasing use automated underwriting.

Multifamily Mortgage Market. The market for financing of multifamily apartments has grown to record volumes. The favorable long-term prospects for apartments, combined with record low interest rates, have kept investor demand for apartments strong and supported property prices. As explained above, Fannie Mae and Freddie Mac have been among those boosting volumes and introducing new programs to serve the multifamily market. The long run outlook for the multifamily rental market is sustained, moderate growth, based on favorable demographics. The minority population, especially Hispanics, provides a growing source of demand for affordable rental housing. ''Lifestyle renters'' (older, middle-income households) are also a fast growing segment of the rental population. However, provision of affordable housing will continue to challenge suppliers of multifamily rental housing and policy makers at all levels of government. Low incomes combined with high housing costs define a difficult situation for millions of renter households. Housing cost reductions are constrained by high land prices and construction costs in many markets. Government action—through land use regulation, building codes, and occupancy standards—are major contributors to those high costs. In addition to fewer regulatory barriers and costs, multifamily housing would benefit from more favorable public attitudes. Higher density housing is a potentially powerful tool for preserving open space, reducing sprawl, and promoting transportation alternatives to the automobile. The recently heightened attention to these issues may increase the acceptance of multifamily rental construction to both potential customers and their prospective neighbors.

2. Past Performance of the GSEs

This section reviews the low- and moderate-income performance of Fannie Mae and Freddie Mac. It first reviews the GSEs' performance on the Low- and Moderate-Income Goal, then reviews findings from Section E.2 regarding the GSEs' purchases of home loans for historically underserved families and their communities. Finally, it reviews findings from Section G concerning the GSEs' presence in owner and rental markets.

a. Housing Goals Performance

In the October 2000 rule, the low- and moderate-income goal was set at 50 percent

[341] National Association of Home Builder, 2004 Spring Construction Forecast Conference, April 21, 2004.

for 2001–03. Effective on January 1, 2001, several changes in counting requirements came into effect for the low- and moderate-income goal, as follows: (a) ''Bonus points'' (double credit) for purchases of mortgages on small (5–50 unit) multifamily properties and, above a threshold level, mortgages on 2–4 unit owner-occupied properties; (b) a ''temporary adjustment factor'' (1.35 units credit) for Freddie Mac's purchases of mortgages on large (more than 50 units) multifamily properties; (c) changes in the treatment of missing data; and (d) a procedure for the use of imputed or proxy rents for determining goal credit for multifamily mortgages. Fannie Mae's performance was 51.5 percent in 2001, 51.8 percent in 2002, and 52.3 percent in 2003; Freddie Mac's performance was 53.2 percent in 2001, 50.5 percent in 2002, and 51.2 percent in 2003—thus both GSEs surpassed this higher goal in all three years.

Counting requirements (a) and (b) expired at the end of 2003, while (c) and (d) will remain in effect after that. If this counting approach—without the bonus points and the ''temporary adjustment factor''—had been in effect in 2000 and 2001, and the GSEs had purchased the same mortgages that they actually did purchase in both years, then Fannie Mae's performance would have been 51.3 percent in 2000, 49.2 percent in 2001, 49.0 percent in 2002, and 48.7 percent in 2003. Freddie Mac's performance would have been 50.6 percent in 2000, 47.7 percent in 2001, 46.1 percent in 2002, and 44.6 percent in 2003. Thus, both Fannie Mae and Freddie Mac would have surpassed the low- and moderate-income goal of 50 percent in 2000 and fallen short in 2001 through 2003. (*See* Figure A.1.)

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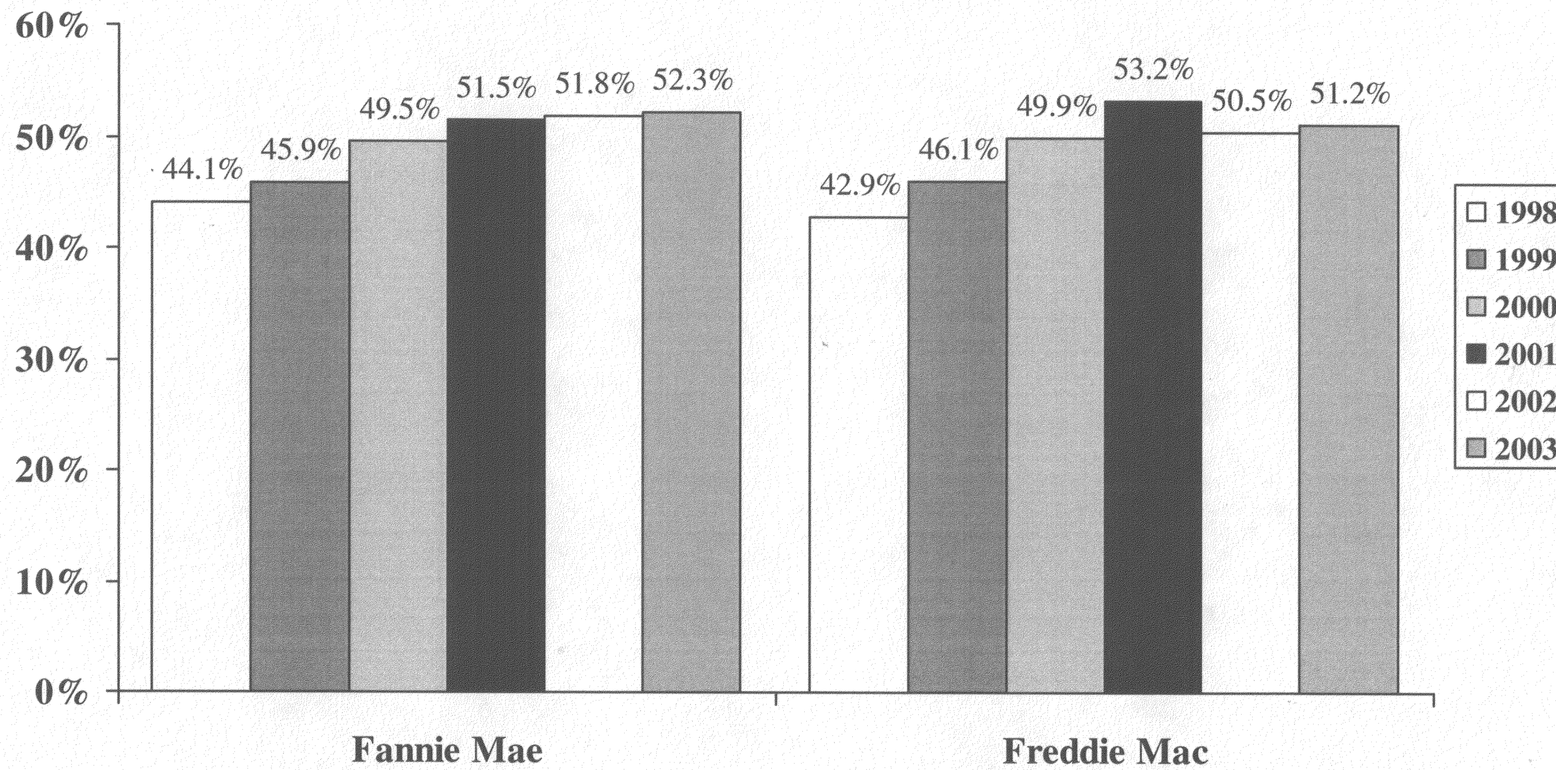
Figure A.1

Low- and Moderate-Income Mortgage Purchases



Low- and Moderate-Income Goal was 42% of units financed for 1998-2000 and 50% for 2001-03.

Source: HUD analysis of GSEs' loan-level data. Due to changes in goal counting procedures in 2001, performance in 2001-03 is not strictly comparable with performance in 1998-2000, as discussed in text.

b. Single-Family Affordable Lending Market

The GSEs have played a major role in the single-family mortgage market over the past ten years. Their purchases of single-family-owner mortgages accounted for 61 percent of all mortgages originated in the single-family conventional conforming market between 1999 and 2002. Their underwriting and purchase guidelines are market standards, used in all segments of the mortgage market. The GSEs have worked to improve their affordable lending record—they have introduced new low-downpayment products targeted at lower-income families; they have customized their underwriting standards to recognize the unique needs of immigrant and minority families; and, they have entered into numerous partnerships with lenders and non-profit groups to reach out to underserved populations. The enterprises' role in the mortgage market is also reflected in their use of cutting edge technology, such as the development of Loan Prospector and Desktop Underwriter, the automated underwriting systems developed by Freddie Mac and Fannie Mae, respectively. Both GSEs are also entering new and challenging fields of mortgage finance, such as purchasing subprime mortgages.

Despite these efforts and the overall gains in goal performance, the Department remains concerned about the GSEs' support of home lending for the lower-income end of the market and for first-time homebuyers. The shares of the GSEs' purchases are too low, particularly for underserved areas and groups such as minority first-time homebuyers.

This appendix included a comprehensive analysis of the GSEs' performance in funding home purchase mortgages for families and communities that historically have not been well served by the mortgage market. The following findings are offered with respect to the GSEs' acquisitions of *home purchase loans* that qualify for the three housing goals (special affordable and underserved areas as well as low- and moderate-income) and their acquisitions of first-time homebuyer loans:

• Fannie Mae and Freddie Mac have both improved their support for the single-family affordable lending market over the past eleven years, but historically over past periods, such as 1993–2003, 1996–2003, and 1999–2003, they have lagged the overall conventional conforming market in providing affordable loans to lower-income borrowers and underserved areas. This finding is based on HUD's analysis of GSE and HMDA data and on numerous studies by academics and research organizations.

• The GSEs have shown different patterns of mortgage purchases. Except for two years (1999 and 2000), Fannie Mae has performed better than Freddie Mac since 1993 on all three goals-qualifying categories—low-mod, special affordable, and underserved areas. As a result, the percentage of Freddie Mac's purchases benefiting historically underserved families and their neighborhoods has been less than the corresponding shares of total market originations, while Fannie Mae's purchases have been somewhat closer to the patterns of originations in the primary market.

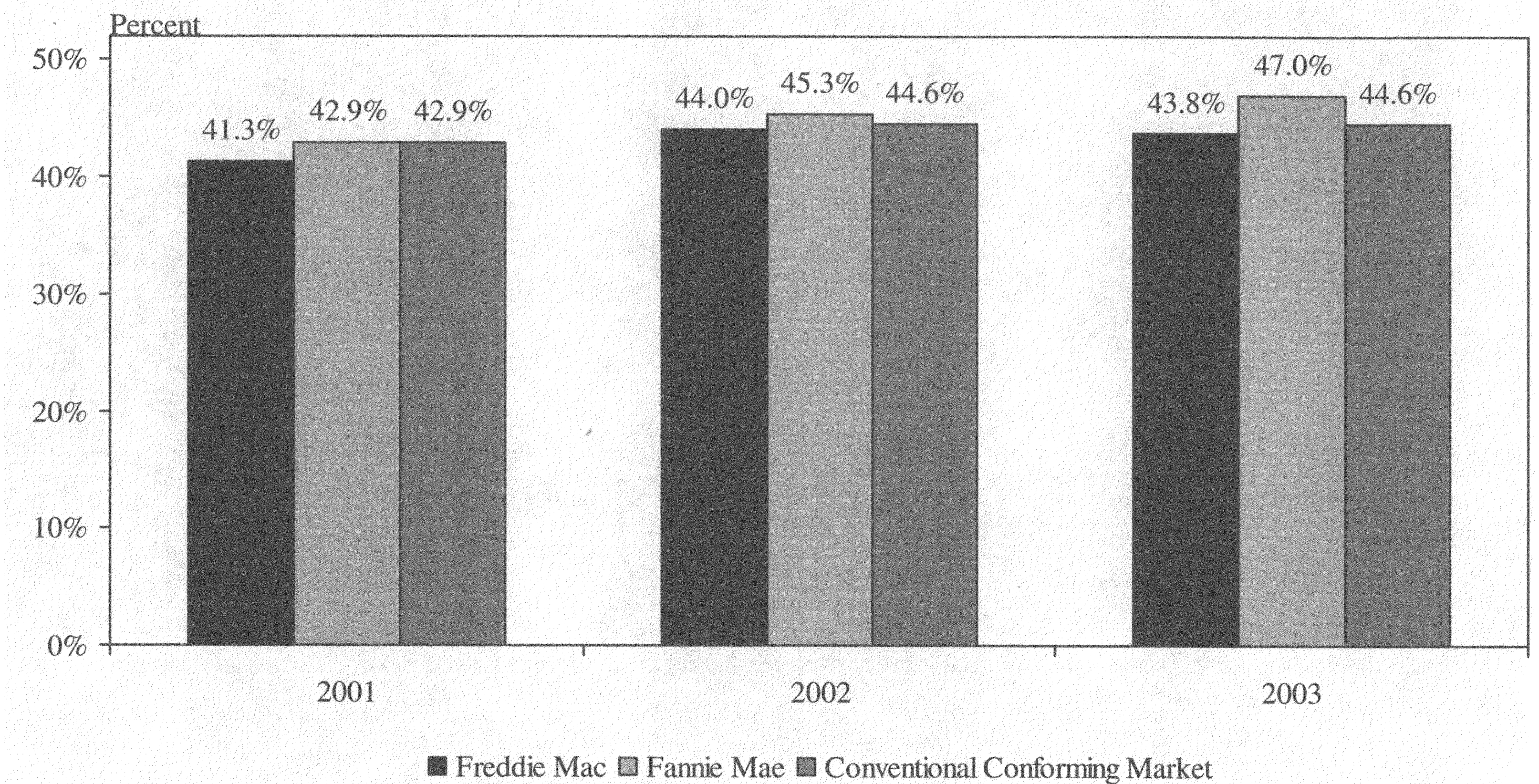
• The above patterns can be seen by the following percentage shares of home purchase loans that qualified for the three housing goals between 1996 and 2003:

	Special affordable (percent)	Low-Mod (percent)	Under-served areas (percent)
Freddie Mac	13.2	40.3	22.0
Fannie Mae	14.1	42.2	24.0
Market (w/o B&C)	15.9	43.6	25.7

• During 2001–2003, Fannie Mae improved its performance enough to lead the special affordable and low-moderate income markets, although it continued to lag the underserved areas market. During 2001–2003, Freddie Mac lagged the conventional conforming market on all three goals-qualifying categories; see Figure A.2 for the low- and moderate-income shares for Fannie Mae, Freddie Mac and the market.

Figure A.2

The Share of GSE and Conventional Conforming Mortgages for Low-and Moderate-Income Borrowers, 2001-2003



Source: Conforming market (without B&C loans) data are from 2001-2003 HMDA; GSE data are from loan-level data reported to HUD. Data are for single-family home purchase loans in metropolitan areas. See Table A.15 for further explanation.

• Both Fannie Mae and Freddie lag the conventional conforming market in funding first-time homebuyers, and by a rather wide margin. Between 1999 and 2001, first-time homebuyers accounted for 27 percent of each GSE's purchases of home loans, compared with 38 percent for home loans originated in the conventional conforming market.

• The GSEs also account for a very small share of the market for important groups such as minority first-time homebuyers. Considering the total mortgage market (both government and conventional loans), it is estimated that the GSEs purchased only 14 percent of loans originated between 1999 and 2001 for African-American and Hispanic first-time homebuyers, or one-third of their share (42 percent) of all home purchase loans originated during that period. Considering the conventional conforming market and the same time period, it is estimated that the GSEs purchased only 31 percent of loans originated for African-American and Hispanic first-time homebuyers, or approximately one-half of their share (57 percent) of all home purchase loans in that market.

To summarize, the Department's analysis suggests that, except for Fannie Mae's recent performance on the special affordable and low-moderate categories, the GSEs have not been leading the single-family-owner market in purchasing goals-qualifying and first-time homebuyer loans. Freddie Mac, in participation, continues to lag the market on all categories considered. There is room for Freddie Mac, as well as Fannie Mae, to further improve their performance in purchasing affordable loans in the underserved portion of the market, particularly in the minority first-time homebuyer market. Evidence suggests that there is a significant population of potential homebuyers who might respond well to aggressive outreach by the GSEs—immigrants and minorities, in particular, are expected to be a major source of future homebuyers. Furthermore, studies indicate the existence of a large untapped pool of potential homeowners among the rental population. Indeed, the GSEs' recent experience with new outreach and affordable housing initiatives is important confirmation of this potential. To move the GSEs into a leadership position, the Department is establishing three subgoals for home purchase loans that qualify for the three housing goals. The low- and moderate-income subgoal is discussed in Section I.3 below.

c. Overall Market Shares

This appendix also included an analysis of the GSEs' role in the *overall* (owner and rental) conventional conforming mortgage market. While GSE mortgage purchases represented 55 percent of total dwelling units financed between 1999 and 2002, they represented smaller shares of the three goals-qualifying markets: 48 percent of housing units financed for both low- and moderate-income families and properties located in underserved areas; and 41 percent of units financed for the very-low-income and other families that qualify as special affordable. (*See* Figure A.3.) In other words, the GSEs accounted for approximately 50 percent or less of the single-family and multifamily units financed in the goals-qualifying markets. This market share analysis suggests that there is room for the GSEs to increase their purchases in these goals-qualifying markets.

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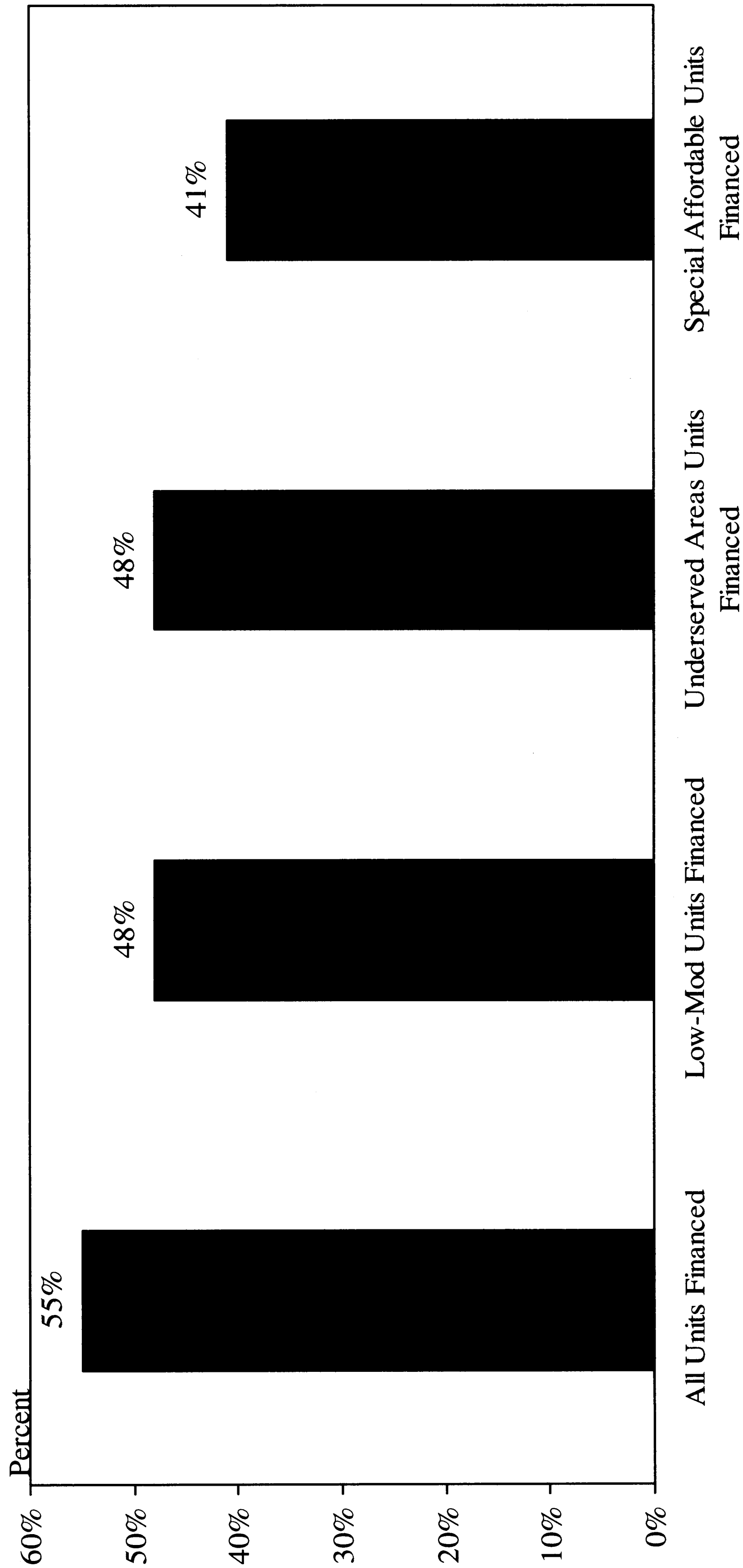
Figure A.3

GSEs' Share of the Conventional Conforming Market by Housing Goal Category, 1999-2002



Source: The conventional conforming market, as estimated by HUD, includes single-family owner, single-family rental, and multifamily units financed during 1999-2002. See notes for Table A.30.

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The market analysis also examined the GSEs' presence in the owner-occupied home purchase mortgage and rental property sectors of the mortgage market: single-family owner (a 61 percent share for the GSEs between 1999 and 2002) and single-family rental and multifamily rental (a combined rental share of 37 percent). The GSEs, and particularly Freddie Mac, have historically played a smaller role in the market financing rental properties, as compared with their role in the owner market. Fannie Mae and Freddie Mac have recently increased their purchases of these mortgages, but their purchases totaled only 37 percent of the rental units that received financing between 1999 and 2002.[342] A further increased presence by Fannie Mae and Freddie Mac would bring lower interest rates and liquidity to this market, as well as improve their housing goals performance.

d. The GSEs' Purchases of Multifamily Mortgages

Fannie Mae and, especially, Freddie Mac have rapidly expanded their presence in the multifamily mortgage market in the period since the passage of FHEFSSA. The Senate report on this legislation in 1992 referred to the GSEs' activities in the multifamily arena as ''troubling,'' citing Freddie Mac's September 1990 suspension of its purchases of new multifamily mortgages and criticism of Fannie Mae for ''creaming'' the market.[343]

Freddie Mac has successfully rebuilt its multifamily acquisition program, as shown by the increase in its purchases of multifamily mortgages: from $27 million in 1992 to $3 billion in 1997 and then to approximately $7 billion during the next three years (1998 to 2000), before rising further to $11.9 billion in 2001, $13.3 billion in 2002, and $21.6 billion in 2003. Multifamily properties accounted for 10.3 percent of all dwelling units (both owner and rental) financed by Freddie Mac during 2003. Concerns regarding Freddie Mac's multifamily capabilities no longer constrain their performance with regard to low- and moderate-income families.

Fannie Mae never withdrew from the multifamily market, but it has also stepped up its activities in this area substantially, with multifamily purchases rising from $3.0 billion in 1992 to $9.4 billion in 1999, $18.7 billion in 2001, $18.3 billion in 2002, and $33.3 billion in 2003. Multifamily units as a share of all dwelling units (both owner and rental) financed by Fannie Mae varied in the 10–13 percent range between 1999 and 2001, before falling to 7.3 percent during heavy refinancing year of 2002 and 8 percent in 2003.

The increased purchases of multifamily mortgages by Fannie Mae and Freddie Mac have major implications for the Low- and Moderate-Income Housing Goal, since a very high percentage of multifamily units have rents which are affordable to low- and moderate-income families. However, the potential of the GSEs to lead the multifamily mortgage industry has not been fully developed. As reported earlier in Tables A.30 and A.31b, the GSEs' purchases between 1999 and 2002 accounted for 35–41 percent of the multifamily units that received financing during this period. Certainly there are ample opportunities and room for expansion of the GSEs' share of the multifamily mortgage market. The GSEs' size and market position between loan originators and mortgage investors makes them the logical institutions to identify and promote needed innovations and to establish standards that will improve market efficiency. As their role in the multifamily market continues to grow, the GSEs will have the knowledge and market presence to push simultaneously for standardization and for programmatic flexibility to meet special needs and circumstances, with the ultimate goal of increasing the availability and reducing the cost of financing for affordable and other multifamily rental properties.

3. Ability to Lead the Single-Family-Owner Market: A Low- and Moderate-Income Subgoal

As discussed in Section E, the Department is proposing to establish a subgoal of 45 percent for each GSE's purchases of home purchase loans for low- and moderate-income families in the single-family-owner market of metropolitan areas for 2005, with the subgoal rising to 46 percent in 2006 and 47 percent in 2007 and 2008. The purpose of this subgoal is to encourage the GSEs to improve their acquisitions of *home purchase* loans for lower-income families and first-time homebuyers who are expected to enter the homeownership market over the next few years. If the GSEs meet this goal, they will be leading the primary market by approximately one percentage point in 2005 and by three percentage points in 2007 and 2008, based on the income characteristics of home purchase loans reported in HMDA. Between 2002 and 2003, HMDA data show that low- and moderate-income families accounted for an (unweighted) average of 44.1 percent of single-family-owner loans originated in the conventional conforming market of metropolitan areas. (The market and GSE data reported in this paragraph are based on ''projected'' data that account for new Census geography and the new OMB metropolitan area definitions; *see* Table A.17b.) Loans in the B&C portion of the subprime market are not included in these averages. To reach the 45-percent (47-percent) subgoal, Freddie Mac would have to improve its performance by 0.8 (2.8) percentage points over its 2003 performance. Fannie Mae would have to keep up its high level (47.5 percent) of performance during 2003. The approach taken is for the GSEs to obtain their leadership position by staged increases in the low-mod subgoal; this will enable the GSEs to take new initiatives in a correspondingly staged manner to achieve the new subgoal each year. Thus, the increases in the low-mod subgoal are sequenced so that the GSEs can gain experience as they improve and move toward the new higher subgoal targets.

As explained in Section E.9, the subgoal applies only to the GSEs' purchases in metropolitan areas because reliable market data for non-metropolitan areas are not available from HMDA. The Department is also setting home purchase subgoals for the other two goals-qualifying categories, as follows: 17–18 percent for special affordable loans and 32–34 percent for underserved area loans (also called Geographically Targeted loans).

The Department considered the following factors when setting the subgoal for low- and moderate-income loans.

(a) *The GSEs have the ability to lead the market.* The GSEs have the ability to lead the primary market for single-family-owner loans, which is the ''bread-and-butter'' of their business. They both have substantial experience in this market, which means there are no issues as whether or not the GSEs have yet penetrated the market, as there are with the single-family rental and multifamily markets. Both GSEs have not only been operating in the owner market for years, they have been the dominant players in that market, funding 61 percent of the single-family-owner mortgages financed between 1999 and 2002. As discussed in Section G, their underwriting guidelines are industry standards and their automated mortgage systems are widely used throughout the mortgage industry. Through their new downpayment and subprime products, and their various partnership initiatives, the GSEs have shown that they have the capacity to reach out to lower-income families seeking to buy a home. Both Fannie Mae and Freddie Mac have the staff expertise and financial resources to make the extra effort to lead the primary market in funding single-family-owner mortgages for low- and moderate-income mortgages, as well for special affordable and undeserved area mortgages.

(b) *GSEs' Performance Relative to the Market.* Even though the GSEs have had the ability to lead the home purchase market, their past average performance (1993–2003, 1996–2003, and 1999–2003) has been below market levels. During 2002 and 2003, Fannie Mae improved its performance enough to lead the low-mod market for home purchase loans, but Freddie Mac, although it also improved its performance during this recent period, continues to lag behind the primary market. The subgoals will ensure that Fannie Mae maintains and further improves its above-market performance and that Freddie Mac not only erases its current gap with the market but also takes a leadership position as well. With respect to the GSEs' historical performance, low- and moderate-income mortgages accounted for 40.3 (42.6) percent of Freddie Mac's purchases during 1996–2003 (1999–2003), for 42.2 (43.6) percent of Fannie Mae's purchases, and for 43.6 (44.1) percent of primary market originations (excluding B&C loans). The type of improvement needed for Freddie Mac to meet this new low-mod subgoal was demonstrated by Fannie Mae during 2001–2003, as Fannie Mae increased its low-mod purchases from 40.8 percent of its single-family-owner business in 2000 to 45.3 percent in 2002 and47.0 percent in 2003. (As noted above, Fannie Mae's 2003 performance was slightly higher at 47.5 percent when measured based on the new 2000 Census geography and new OMB definitions.)

[342] As shown in Table A.31b, the GSEs' share of the rental market increases to 41 percent when a lower multifamily share is assumed in the market analyses.

[343] Senate Report 102–282, May 15, 1992, p. 36.

(c) *Disparities in Homeownership and Credit Access Remain.* There remain troublesome disparities in our housing and mortgage markets, even after the ''revolution in affordable lending'' and the growth in homeownership that has taken place since the mid-1990s. The homeownership rate for African-American and Hispanic households remains 25 percentage points below that of white households. Minority families face many barriers in the mortgage market, such as lack of capital for down payment and lack of access to mainstream lenders (see above). Immigrants and minorities are projected to account for almost two-thirds of the growth in the number of new households over the next ten years. As emphasized throughout this Appendix, changing population demographics will result in a need for the primary and secondary mortgage markets to meet nontraditional credit needs, respond to diverse housing preferences and overcome information and other barriers that many immigrants and minorities face. The GSEs have to increase their efforts in helping these families because so far they have played a surprisingly small role in serving minority first-time homebuyers. It is estimated that the GSEs accounted for 46.5 percent of all (both government and conventional) home loans originated between 1999 and 2001; however, they accounted for only 14.3 percent of home loans originated for African-American and Hispanic first-time homebuyers. Within the conventional conforming market, it is estimated that the GSEs purchased only 20 percent of loans originated for African-American and Hispanic first-time homebuyers, even though they accounted for 57 percent of all home purchase loans in that market. A subgoal for home purchase loans should increase the GSEs' efforts in important sub-markets such as the one for minority first-time homebuyers.

(d) *There are ample opportunities for the GSEs to improve their performance.* Low- and moderate-income loans are available for the GSEs to purchase, which means they can improve their performance and lead the primary market in purchasing loans for borrowers with less-than-median income. Three indicators of this have already been discussed. First, Sections B and C of this appendix and Appendix D explain that the affordable lending market has shown an underlying strength over the past few years that are unlikely to vanish (without a significant increase in interest rates or a decline in the economy). The low-mod share of the home purchase market has averaged 43.6 percent since 1996 and annually has ranged from 42.1 percent to 44.8 percent. Second, the market share data reported in Table A.30 of Section G demonstrate that there are newly-originated low- and moderate-income loans available each year for the GSEs to purchase. As noted above, the GSEs have only a minimal presence in special sub-markets such the minority first-time homebuyer market, which suggests there are ample opportunities available for the GSEs to increase their purchases of loans for low- and moderate-income families. Finally, the GSEs' purchases under the subgoal are not limited to new mortgages that are originated in the current calendar year. The GSEs can purchase loans from the substantial, existing stock of affordable loans held in lenders' portfolios, after these loans have seasoned and the GSEs have had the opportunity to observe their payment performance. In fact, based on Fannie Mae's recent experience, the purchase of seasoned loans appears to be one useful strategy for purchasing goals-qualifying loans.

For the reasons given above, the Secretary believes that the GSEs can do more to raise the low- and moderate-income shares of their mortgages on these properties. This can be accomplished by building on various programs that the enterprises have already started, including (1) their partnership and outreach efforts, (2) their incorporation of greater flexibility into their underwriting guidelines, (3) their purchases of CRA loans, and (4) their targeting of important markets where they have had only a limited presence in the past, such as the market for minority first-time homebuyers. A wide variety of quantitative and qualitative indicators indicate that the GSEs' have the resources and financial strength to improve their affordable lending performance enough to lead the market for low- and moderate-income families. The recent experience of Fannie Mae indicates that the GSEs can lead the low- and moderate-income market.

4. Size of the Mortgage Market for Low- and Moderate-Income Families

As detailed in Appendix D, the low- and moderate-income mortgage market accounts for 51 to 56 percent of dwelling units financed by conventional conforming mortgages. In estimating the size of the market, HUD excluded the effects of the B&C market. HUD also used alternative assumptions about future economic and market affordability conditions that were less favorable than those that existed over the last five years. HUD is well aware of the volatility of mortgage markets and the possible impacts of changes in economic conditions on the GSEs' ability to meet the housing goals. Should conditions change such that the goals are no longer reasonable or feasible, the Department has the authority to revise the goals.

5. The Low- and Moderate-Income Housing Goal for 2005–2008.

The Low- and Moderate-Income Housing Goal is 52 percent of eligible units for 2005, 53 percent for 2006, 55 percent for 2007, and 56 percent for 2008. The market for the Low- and Moderate-Income Goal is estimated to be 51–56 percent. Under the new counting rules (*i.e.*, 2000-Census income re-benchmarking and the new OMB metropolitan area definitions), Fannie Mae's low- and moderate-income performance is estimated to have been 46.3 percent in 1999, 51.2 percent in 2000, 48.7 percent in 2001, 47.9 percent in 2002, and 49.5 percent in 2003—for 2005, Fannie Mae would have to increase its performance by 3.3 percentage points over its average (unweighted) performance of 48.7 percent over these last five years, or by 0.8 percentage point over its previous peak performance (51.2 percent in 2000). By 2008, Fannie Mae's performance would have to increase by 6.3 percentage points over average 1999–2003 performance, and by 5.8 percentage points over its previous peak performance in 2000. Freddie Mac's performance is estimated to have been 46.0 percent in 1999, 50.2 percent in 2000, 47.0 percent in 2001, 44.6 percent in 2002, and 45.3 percent in 2003—for 2005, Freddie Mac would have to increase its performance by 5.3 percentage points over its average (unweighted) performance of 46.7 percent over these last five years, or by 1.8 percentage points over its previous peak performance (50.2 percent in 2000). By 2008, Freddie Mac's performance would have to increase by 9.3 percentage points over average 1999–2003 performance, and by 5.8 percentage points over its previous peak performance. However, the low- and moderate-income market is estimated to be 51–56 percent. Thus, the GSEs should be able to improve their performance enough to meet these goals of 52–56 percent.

The objective of the Low- and Moderate-Income Goal is to bring the GSEs' performance to the upper end of HUD's market range estimate for this goal (51–56 percent), consistent with the statutory criterion that HUD should consider the GSEs' ability to lead the market for each Goal. To enable the GSEs to achieve this leadership, the Department is proposing modest increases in the Low- and Moderate-Income Goal for 2005 which will increase further, year-by-year through 2008, to achieve the ultimate objective for the GSEs to lead the market under a range of foreseeable economic circumstances by 2008. Such a program of staged increases is consistent with the statutory requirement that HUD consider the past performance of the GSEs in setting the Goals. Staged annual increases in the Low- and Moderate-Income Goal will provide the enterprises with opportunity to adjust their business models and prudently try out business strategies, so as to meet the required 2008 level without compromising other business objectives and requirements.

Figure A.3 summarizes many of the points made in this section regarding opportunities for Fannie Mae and Freddie Mac to improve their overall performance on the Low- and Moderate-Income Goal. The GSEs' purchases provided financing for 26,118,927 (or 55 percent) of the 47,551,039 single-family and multifamily units that were financed in the conventional conforming market between 1999 and 2002. However, in the low- and moderate-income part of the market, the 12,608,215 units that were financed by GSE purchases represented only 48 percent of the 26,051,771 dwelling units that were financed in the market. Thus, there appears to be ample room for the GSEs to increase their purchases of loans that qualify for the Low- and Moderate-Income Goal. Examples of specific market segments that would particularly benefit from a more active secondary market have been provided throughout this appendix.

6. Conclusions

Having considered the projected mortgage market serving low- and moderate-income families, economic, housing and demographic conditions for 2005–08, and the GSEs' recent performance in purchasing mortgages for low- and moderate-income families, the Secretary has determined that